Securities Industry
Trends

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$36.00 member • $60.00 non-member

AN ANALYSIS OF EMERGING TRENDS IN THE SECURITIES INDUSTRY
Produced by the SIA Research Department

A8825-1

Vol. XI, No.7 October 29, 1985

# The 1H 1985 Profitability Performance of the Securities Industry

## Highlights

1. The industry's annualized 1H 1985 after-tax ROE rose to 16% from only 7% in 1984 because of a 17% climb in total revenues due to a favorable interest rate environment and a modest 9% increase in total expenses resulting from the imposition of cost controls in 1984 as well as the drop in interest expense. Importantly, pre-tax net income during the 1H of 1985 exceeded that for all of 1984 by almost 25%.

2. Unlike 1984, the firm categories' ROEs in the 1H 1985 were more uniform and pre-tax income more evenly distributed. Large Investment Banks continued to be the most profitable firm category.

3. Nearly 90% of the climb in proximate non-interest revenues, which excludes other-related revenues and margin interest, was accounted for by increases in trading profits, commissions, mutual fund sales and underwriting.

4. Annualized 1H 1985 revenues from mutual fund sales jumped to $1.5 billion compared with $750 million in 1984. This climb was so sharp that it accounted for a larger proportion (15%) of the 1H 1985 increase in proximate non-interest revenues than any other revenue source except trading profits and commissions.

5. Cost constraint policies instituted in 1984 were effective in limiting industry expense increases in 1H 1985 as activity rose. Annualized non-interest expenses rose 15% in 1H 1985 compared with a 1979 to 1984 compound annual growth rate of 22%. So-called fixed expenses increased an annualized 10% in 1H 1985, significantly lower than the 1979 to 1984 compound annual growth rate of 25%.

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## I. Introduction

The securities industry's profitability improved significantly in the 1H 1985 because of higher revenues due to lower interest rates and expectations that monetary policy would prevent rates from rising sharply. In addition, expenses increased relatively modestly because of extensive cost controls instituted in 1984 which continued during the 1H 1985 as well as lower interest expense resulting from declining rates. The industry's annualized 1H 1985 after-tax return-on-equity (ROE) rose to 16% from 7% in 1984, its lowest level since 1977 (Table 1). After combining the first and second quarters of 1985, an estimated 80% of the NYSE firms doing a public business were profitable in the 1H 1985 compared with 65% in 1984.

Table 1

After-Tax Return-on-Equity[1]

| Firm Categories | 1984 | Annualized 1H 1985 | Change in Percentage Points, 1984-Annal.1H1985 |
|---|---|---|---|
| National Full-Line | (2.4)% [2] | 9.8% | 12.2 |
| Large Investment Banks | 16.8 | 21.8 | 5.0 |
| N.Y.C. Based Regional | 10.8 | 18.9 | 8.1 |
| Regional | 3.7 | 15.5 | 11.8 |
| Discounters | (2.4)[2] | 11.1 | 13.5 |
| Industry | 7.2% | 16.4% | 9.2 |

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[1] For NYSE firms doing a public business.

[2] Pre-tax ROE

( ) Negative

Source: Securities Industry Database

Profitability also rose in the 1H 1985 for all firm categories because of increases in agency and principal businesses. Unlike 1984, ROE levels in the 1H 1985 were more uniform and pre-tax income more evenly distributed among the firm categories. However, Large Investment Banks (LIBs) continued to be the most profitable firm category. Profitability plummeted in 1984 for most categories largely because of the drop in equity related business as LIBs received 72% of the industry's total pre-tax income.

Annualized pre-tax income climbed nearly 150% in the 1H 1985 compared to 1984. Revenues increased almost 17% because of improved business conditions, while expenses rose only 9% largely because of the drop in interest expense and the comparatively small rise in so-called fixed expenses. As a result, the industry's pre-tax profit margin jumped to 11% from 5% in 1984.

## Revenues

Annualized total revenues rose by $5.6 billion to $36 billion in 1H 1985 while proximate non-interest revenues, which excludes margin interest and other-related revenues, climbed by $4.6 billion to $27 billion (Table 2).[1] Largely responsible for these increases were higher revenues from trading activities, commissions, mutual fund sales and underwriting.

### Commissions

Annualized commissions increased almost 17% in the 1H 1985, in contrast to a 15% drop in 1984. Also, commissions were responsible for 22% of the rise in proximate non-interest revenues. Although annualized 1H 1985 commissions were near their 1983 record level, they were not the largest revenue source. As in 1984, commissions were overshadowed by trading profits.

Commissions rose in the 1H 1985 because of a nearly 16% increase in publicly traded share volume and a rise in the average price per share of stock traded (Table 3).[2] On the NYSE, the average price per share of stock traded rose to $35 in the 1H 1985 from $33 in 1984. Interest in equities increased in the 1H 1985 as expectations developed that interest rates would be reduced to stimulate the economy and, consequently, corporate profits.

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[1] A comparison of proximate non-interest revenues and non-interest expenses helps to better understand the reasons for the change in profitability by minimizing the effects of interest rate trends on revenues and expenses.

[2] Total publicly traded share volume including purchases and sales less member trading on the NYSE, AMEX and regional exchanges is estimated to have risen from 43.8 billion shares in 1984 to an annualized 50.6 billion shares in 1H 1985, or by almost 16%. Firms generally obtain mark-ups from customer transactions in NASDAQ stocks rather than commissions. Consequently, these mark-ups are reported in trading profits and not in commissions.

## Table 2

## Securities Industry Revenues, 1984 and 1H 1985

(millions of dollars)

| | 1984 | 1H 1985 | |
|---|---|---|---|
| Revenues[1] | | Actual | Annualized |
| Commissions | | | |
| Listed Equities on and Exchange | $5,232.6 | $3,074.1 | $6,148.2 |
| Listed Equities Executed OTC | 75.0 | 41.10 | 82.0 |
| Listed Options | 822.3 | 442.8 | 885.6 |
| Other | 964.7 | 581.2 | 1,162.4 |
| Total | 7,094.6 | 4,139.2 | 8,278.4 |
| Trading Profits | | | |
| Market Making OTC | 862.9 | 621.3 | 1,242.6 |
| Debt Securities | 5,524.9 | 3,510.0 | 7,020.0 |
| Options on Nat'l Exchange | 31.1 | 86.3 | 172.6 |
| Other | 1,147.7 | 577.2 | 1,154.4 |
| Total | 7,563.8 | 4,793.9 | 9,587.8 |
| Investment Profits | | | |
| Realized | 697.7 | 412.8 | 825.6 |
| Unrealized | (10.4) | 63.6 | 127.2 |
| Total | 713.8 | 517.7 | 1,035.4 |
| Underwriting | | | |
| Debt | 2,457.8 | 1,422.0 | 2,844.0 |
| Equity Securities | 248.3 | 286.5 | 573.0 |
| Total | 2,706.1 | 1,708.5 | 3,417.0 |
| Margin Interest | 2,867.8 | 1,207.6 | 2,415.2 |
| Mutual Fund Sales | 750.9 | 774.7 | 1,549.4 |
| Account Supervision | 693.8 | 405.2 | 810.4 |
| Research | 11.1 | 7.1 | 14.2 |
| Commodities | 739.3 | 554.9 | 1,109.8 |
| Other-Related | 6,282.8 | 3,287.6 | 6,575.2 |
| Other-Unrelated | 1,792.1 | 781.7 | 1,563.4 |
| TOTAL REVENUES | $31,216.0 | $18,178.1 | $36,356.2 |
| TOTAL EXPENSES | $29,608.2 | $16,177.2 | $32,354.4 |
| PRE-TAX NET INCOME | $1,607.8 | $2,000.9 | $4,001.8 |

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[1] Discrepancies may exist due to rounding.

( ) Negative

Source: Securities Industry Database

## Table 3

## Equity Sales Volume, Price and Value

### 1H 1985

| Registered Stock Exchanges | Average Daily Share Volume (In Millions) | Annualized Share Volume (In Millions) | Price/Share Traded | Annualized Dollar Value of Shares Traded (In Millions) |
|---|---|---|---|---|
| NYSE[1] | 107.8 | 26,944 | $35.00 | $945,973 |
| AMEX[2] | 8.3 | 2,070 | 12.52 | 26,176 |
| Regional Exchanges[2] | 18.8 | 4,597 | 31.50 | 144,801 |
| | 134.9 | 33,611 | $33.23 | $1,116,950 |

### 1984

| Registered Stock Exchanges | Average Daily Share Volume (In Millions) | Annualized Share Volume (In Millions) | Price/Share Traded | Annualized Dollar Value of Shares Traded (In Millions) |
|---|---|---|---|---|
| NYSE[1] | 91.2 | 23,071 | $33.15 | $764,737 |
| AMEX[2] | 6.1 | 1,545 | 13.82 | 21,349 |
| Regional Exchanges[2] | 14.1 | 3,571 | 33.70 | 120,359 |
| | 111.4 | 28,187 | $32.16 | $906,445 |

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[1] Round-lot data.

[2] Includes round-lot and odd-lot.

Sources: NYSE, AMEX, regional exchanges, NASD and SEC.

## Trading Profits

Trading profits continued to be the most important driving force behind the growth in industry revenues. In the 1H 1985, annualized trading profits climbed 27% to $9.6 billion from $7.6 billion in 1984. Its growth was responsible for about 38% of the rise in 1H 1985 proximate non-interest revenues. In addition, the proportion of trading profits to total revenues rose to 26% in the 1H 1985 from 24% in 1984, and was the largest revenue source in both periods.

Annualized 1H 1985 trading profits on debt securities rose to $7.0 billion from $5.5 billion in 1984. A favorable interest rate environment fueled this 27% increase although during the early part of the 1Q 1985 interest rates rose. Thereafter, interest rates fell from the middle of March through the 1H 1985. For example, the rate on long-term Treasury securities dropped from nearly 12% at the end of March to 10.5% at the end of June. The 1H 1985 jump in trading profits on debt securities accounted for nearly 75% of the increase in total trading profits.

Annualized trading profits from OTC market making climbed by 44% in the 1H 1985 as investors became more active in this market. NASDAQ average daily share volume rose to 79.6 million shares in 1H 1985 from 59.9 million shares in 1984, a 33% increase. Also, the NASDAQ Composite Index went up to 296.2 at the end of 1H 1985 from 247.4 at year-end 1984, a 20% rise. OTC market making was responsible for almost 20% of the rise in total trading profits. In contrast, the uncertain economic environment and high real interest rates in 1984 caused investors to be diverted from equities and resulted in trading profits from OTC market making activities plunging by nearly 38%.

Underwriting

Annualized 1H 1985 underwriting revenues climbed to $3.4 billion, which at this level would exceed the 1983 record high. In 1984, underwriting revenues plunged by 24%. This strong 1H 1985 performance occurred because underwriting revenues from debt securities were increasing at a record pace while revenues from equities were rising at a rate only surpassed by the record achieved in 1983.

Annualized 1H 1985 corporate underwriting volume on a net proceeds basis rose to $115 billion which would exceed the record $97 billion set in 1983 (Table 4). In 1984, corporate underwriting volume dropped to $82 billion. Debt financing was at an $87 billion annualized level in the 1H 1985, significantly above the $69 billion record set in 1983. Common stock and IPO issues both experienced substantial increases in the 1H 1985 and, on an annualized basis, would only be exceeded by 1983 activity.

Corporate underwriting volume in the 1H 1985 was at a high level because of the need and opportunities to restructure balance sheets. At the end of 1984, non-financial corporate business' proportion of short-term liabilities to total liabilities was 59%. In addition, equity ratios had been reduced by the significant number of mergers which had to be addressed during favorable market conditions. Corporate AAA bond rates fell from 12% at the end of 1984 to below 11% at the end of the 1H 1985. The NYSE Composite Stock Index rose fairly consistently from 96.4 at the end of 1984 to 111.1 by the end of the 1H 1985.

### Table 4

### Underwriting Volume

(billions of dollars)

| | 1984 | | 1H 1985 | | | |
|---|---|---|---|---|---|---|
| | | | Actual Data | | Annualized Date | |
| | Dollars | No. of Issues | Dollars | No. of Issues | Dollars | No. of Issues |
| Corporate | | | | | | |
| Bonds | $69.3 | 648 | $43.3 | 581 | $86.6 | 1,162 |
| Preferreds | 3.9 | 70 | 3.1 | 48 | 6.2 | 96 |
| Common | 8.9 | 557 | 11.1 | 331 | 22.2 | 662 |
| IPOs | 3.9 | 354 | 2.6 | 131 | 5.3 | 262 |
| | $82.2 | 1,275 | $57.6 | 960 | $115.2 | 1,920 |
| Municipal | | | | | | |
| Rev. Bonds | $74.4 | NA | $35.4 | NA | $70.8 | NA |
| GOs | 27.5 | NA | $17.9 | NA | 35.8 | NA |
| | $101.9 | NA | $53.3 | NA | $106.6 | NA |

NA Not Available

Sources: Dealers' Digest Inc. and The Bond Buyer

Municipal volume in the 1H 1985 was increasing at an annualized pace that would exceed the record set in 1984 by about 5%. This high level of activity resulted from the changes proposed for municipal securities in the Administration's and Treasury's tax proposals as well as the decline in interest rates. The rate on municipal bonds fell from about 10.0% at the end of 1984 to 8.7% at the end of the 1H 1985.[3]

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[3] Bond Buyer's average index of 20 municipal bonds.

During the past years, there have been increases in the proportion of both corporate debt and equity underwriting volumes which have not been distributed through syndicates (Table 5). In 1H 1985, 40% of debt underwriting volume and 36% of equity underwriting volume were distributed without syndicates.[4] This has occurred because the larger highly capitalized firms have retained greater proportions of merchandise in order to increase revenues with the drop in gross spreads due to price and cost pressures, and to have enough product to meet the needs of both retail and institutional customers.

Table 5

Corporate Underwriting Volume Distributed Through Syndicates and Non-Syndicates

(billions of dollars)

| | 1983 | | 1984 | | 1H 1985 | |
|---|---|---|---|---|---|---|
| | Dollars | % of Total | Dollars | % of Total | Dollars | % of Total |
| Debt | | | | | | |
| Syndicated | $36.0 | 69.1% | $40.6 | 58.6% | $26.2 | 59.9% |
| Non-Syndicated | 16.1 | 30.9 | 28.8 | 41.5 | 17.5 | 40.1 |
| | $52.1 | 100.0% | $69.4 | 100.0% | $43.7 | 100.0% |
| Equity | | | | | | |
| Syndicated | $39.7 | 88.0% | $10.3 | 78.9% | $ 9.1 | 63.8% |
| Non-Syndicated | 5.4 | 12.0 | 2.8 | 21.1 | 5.1 | 36.2 |
| | $45.1 | 100.0% | $13.1 | 100.0% | $14.2 | 100.0% |

Source: Investment Dealer's Digest Information Services, Inc.

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[4] Investment Dealers' Digest Information Services, Inc.

Concentration in underwriting revenues increased in 1H 1985 for the Top 10 firms, dropped for the Top 11-25 firms, and rose for the Rest of the Industry (Table 6). The Top 10 firms' proportion increased in the 1H 1985 partly because of the rise in the proportion of volume distributed by these firms without syndicates and the 1984 acquisition of Lehman Brothers, a Top 11-25 firm, by Shearson/American Express. The Rest of the Industry's higher proportion of underwriting revenues resulted largely because of the rise in equity offerings, particularly IPOs, where smaller firms play an important role in originating, underwriting and distributing these securities.

Table 6

Concentration in Underwriting Revenues

| Firm Rankings[1] | 1980 | 1981 | 1982 | 1983 | 1984 | 1H 1985 |
|---|---|---|---|---|---|---|
| Top 10 | 53.1% | 50.4% | 57.8% | 46.2% | 47.8% | 52.0% |
| Top 11-25 | 22.6 | 23.3 | 22.8 | 29.9 | 33.9 | 29.0 |
| Top 25 | 75.6 | 73.7 | 80.5 | 76.1 | 81.7 | 81.1 |
| Rest of Industry | 24.3 | 26.3 | 19.5 | 24.0 | 18.3 | 18.9 |
| | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% |

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[1] Firm rankings are by capital.

Source: Securities Industry Database

## Mutual Fund Sales

Mutual fund sales revenue increased dramatically in the 1H 1985, soaring to an annualized level of $1.5 billion. Record revenues of $952 million were established in 1983, but in 1984 revenues dropped to $751 million. Significantly, the 1H 1985 climb in revenues from mutual funds sales was so large that it accounted for 15% of the increase in annualized proximate non-interest revenues, a larger proportion than any other revenue source except trading profits and commissions.

Total sales of mutual funds less reinvested dividends amounted to $46 billion for the 1H 1985, exceeding the total for *all* of 1984 (Table 7).[5] Increased investors' purchases occurred because of the drop in short-term interest rates and strong markets for equities and longer-term debt instruments. The yield curve remained positive throughout the 1H 1985 as rates on long-term Treasury securities exceeded the rate on the three-month Treasury bill by about 3.7 percentage points at both the beginning and end of this six-month period. Huge amounts of stock and bond funds were added to investors' portfolios. Sales force directed volume, which encompasses brokers-dealers, amounted to about $33 billion or 72% of the total.

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[5] Investment Company Institute

Table 7

Mutual Fund Sales[1]

(billions of dollars)

| | 1984 | Actual 1H 1985 |
|---|---|---|
| Stock Funds | | |
| Appreciation | $18.2 | $13.2 |
| Income | 2.7 | 2.3 |
| | $20.9 | $15.5 |
| Bond Funds | | |
| Government | $5.8 | $13.0 |
| GNMA | 2.9 | 3.9 |
| Corporate | 4.3 | 3.6 |
| Municipal | 9.8 | 8.3 |
| | $22.8 | $28.8 |
| Balanced | $ .2 | $ .2 |
| Option Income | 1.9 | 1.7 |
| TOTAL | $45.8 | $46.2 |

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[1] Excludes short-term funds.

Source: Investment Company Institute

## Other-Related

Annualized other-related revenues to the securities business increased a modest 5% in the 1H 1985. Its compound annual growth rate from 1977 to 1984 was about 45%. The main components of this revenue source are interest earned on the repo business, M&A fees, private placement fees and interest earned on investments. Interest earned on the repo business is believed to be the largest component of this revenue item. The average overnight repo rate decreased from 10.1% in 1984 to 8.1% in the 1H 1985, while the average amount of reverse repos climbed 20%, from $87 billion in 1984 to $104 billion in the 1H 1985.

Data on 1H 1985 M&A fees are not yet available from W.T. Grimm & Co., but indications are that the pace was somewhat slower than that set in 1984. Activity among publicly traded firms appears to have held up because many corporations are restructuring by either selling off divisions or buying companies in efforts to ward off takeover attempts. However, acquisitions of privately held firms seems to have slackened relative to the high levels that existed during recent years. Some private firms do not want to be acquired at this time because of their reduced values due to the uncertain outlooks for their industries.

The level of private placements in the 1H 1985 was comparable to the record high of 1984. In 1H 1985, actual volume was $26.2 billion with 839 issues placed, while in 1984 volume was $53.1 billion and issues 1,781. The private placement market is growing dramatically. Contributing to this growth have been leveraged buy-outs, equipment leasing and mortgage pass-through certificates. Traditional private placements are becoming a smaller part of this market because of Rule 415, which makes it cheaper to raise such funds in the public market.[6]

## Conclusion

Growth in proximate non-interest revenues have slowed relative to their 1976 to 1983 compound annual growth rate of 25%. In the 1H 1985, they rose an annualized 24% after actually falling by 4% in 1984.

## Expenses

When industry profitability fell in 1984 to its lowest level since 1977, firms adopted policies to limit overall costs. These 1984 actions helped limit 1H 1985 expenses. Also, cost constraint policies were still effective in the 1H 1985. On an annualized basis, total expenses rose only 9% while revenues climbed nearly 17% (Table 8). Non-interest expenses increased 15%, compared with a 24% jump in proximate non-interest revenues. The 1979 to 1984 compound annual growth rate for non-interest expenses was 22%.

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[6] "Investment Dealers's Digest," August 12, 1985, p.12.

## Table 8

## Securities Industry Expenses

(millions of dollars)

| Expenses[1/] | 1984 | 1H 1985 | |
|---|---|---|---|
| | | Actual | Annualized |
| Registered Rep. Comp. | $5,248.5 | $3,287.7 | $6,575.4 |
| Clerical & Admin. | 5,147.5 | 2,909.4 | 5,818.8 |
| Partners' & Stock | 934.1 | 534.0 | 1,068.0 |
| Other Employee Comp. | 396.7 | 181.6 | 363.2 |
| Floor Brokerage & Clearance | 1,162.6 | 660.5 | 1,321.0 |
| Fl. Brok.-Brokers | 399.1 | 218.8 | 437.6 |
| Comm. & Clear Others | 395.3 | 224.1 | 448.2 |
| Clear. Pd. Non-Brokers | 257.9 | 156.2 | 312.4 |
| Comm. Pd.-Other Brokers | 110.7 | 61.4 | 122.8 |
| Communications | 1,766.4 | 941.0 | 1,882.0 |
| Occupancy & Equipment | 1,503.7 | 863.2 | 1,726.4 |
| Promotional Costs | 769.2 | 380.9 | 761.8 |
| Interest | 9,505.4 | 4,610.3 | 9,220.6 |
| Error Accts. & Bad Debts | 212.0 | 114.5 | 229.0 |
| EDP Equipment Costs | 419.8 | 225.6 | 451.2 |
| Non-recurring Charges | 26.2 | 8.8 | 17.6 |
| Regulatory Fees & Exp. | 144.9 | 104.3 | 208.6 |
| Other | 2,372.3 | 1,355.3 | 2,710.6 |
| TOTAL EXPENSES | $29,608.2 | $16,177.2 | $32,354.4 |

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[1/] Discrepancies may exist due to rounding.

Source: Securities Industry Database

## Employment

Annualized employment expenses rose by 18% in the 1H 1985, accounting for 65% of the rise in non-interest expenses. Improved business conditions prompted most of this increase. RR compensation, which is directly related to production, rose by 25% and accounted for 44% of the increase in non-interest expenses. Average RR employment rose to 77,770 in the 1H 1985 from 70,840 in 1984. Clerical and administrative employee expenses increased 13%, which was responsible for 22% of the rise in non-interest expenses. Compensation for a significant proportion of employees in this group, such as traders and investment bankers, is also tied to production. Employment, other than RRs, averaged 132,200 in the 1H 1985 compared with 136,835 in 1984.

## Fixed Expenses

The industry's efforts to constrain expenses were evident in so-called fixed expenses which rose by only 10% in the 1H 1985 on an annualized basis. Their compound annual growth rate from 1979 to 1984 was nearly 25%.

The limited 1H 1985 rise in fixed expenses was partly due to the cost constraint policies instituted during 1984. Expenditures for communications and EDP equipment often occur with a lag. Apparently, orders for such equipment were significantly reduced during 1984. Annualized 1H 1985 expenses for communications rose only 6.5% and EDP equipment increased just 7.5%. In contrast, the 1979 to 1984 compound annual growth rate for communications was 21% and for EDP equipment, 28%. Occupancy & equipment expense increases are more difficult to limit in the short-run because of contractual commitments made several years before. In the 1H 1985, annualized occupancy & equipment expenses increased 15%, significantly below its 1979 to 1984 compound annual growth rate of nearly 29%.

## Conclusion

The comparatively modest 1H 1985 9% annualized increase in total expenses contributed importantly to the climb in industry profitability. Interest expense fell by an annualized $285 million, reducing total expenses by about 10%. So-called fixed expenses rose by 10%, significantly lower than the 1979 to 1984 compound annual growth rate of 25%. As a result of the industry's limited increase in expenses and the climb in total revenues, actual pre-tax net income was $2.0 billion in the 1H 1985 which exceeded the industry's profits for all of 1984 by 25%. At this rate, pre-tax net income for all of 1985 would reach $4.0 billion.

Unfortunately, there are indications that profitability slowed considerably in 3Q 1985 from 1H 1985 pace. Commissions decreased as average daily share volume fell on the NYSE to 99.1 million shares in the 3Q 1985 from 107.8 million shares in 1H 1985 and on the AMEX to 7.2 million shares in the 3Q 1985 compared with 8.3 million shares in 1H 1985. Trading profits also appear to have declined from their 1H 1985 level. Trading profits on debt securities probably fell in 3Q 1985 as interest rates on long-term Treasury securities rose to 10.8% at the end of September from 10.4% in June without much volatility presenting trading opportunities. Trading profits on OTC market making also appear to have dropped in the 3Q 1985 as the NASDAQ Composite Index fell to 280 at the end of September from 296 in June. In addition, interest expense increased in the 3Q 1985 because of rising rates. Due to the less favorable interest rate environment in the 3Q 1985, the industry's pre-tax net income is not likely to continue at the same pace as the 1H 1985. Instead, pre-tax net income should reach about $3.5 billion for the year given trends through the first three quarters of 1985.

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VOLUME

|  | SEPTEMBER 1985 | YEAR-TO-DATE 1985 | SEPTEMBER 1984 | YEAR-TO-DATE 1984 | % CHAN. Y-T-D 1985-1984 |
|---|---|---|---|---|---|
| AVERAGE DAILY SHARE VOLUME ON |  |  |  |  |  |
| NYSE (MILS.)* | 97.9 | 104.8 | 93.1 | 92.1 | 13.8% |
| AMEX (MILS.)* | 7.0 | 8.0 | 6.0 | 6.1 | 30.4% |
| NASDAQ (MILS.)* | 74.4 | 77.6 | 62.6 | 60.0 | 29.4% |
| REGIONAL EXCHANGE (MILS.)* | N/A | N/A | 14.8 | 14.3 | N/A |
| DOLLAR VALUE OF SHARES TRADED ON |  |  |  |  |  |
| NYSE (MILS.) | $66,237 | $691,539 | $59,684 | $581,930 | 18.8% |
| AMEX (MILS.) | 1,666 | 18,805 | 1,398 | 15,304 | 22.9% |
| ODD-LOT SHARES PURCHASED ON NYSE (THOUS.) | 4,711 | 59,330 | 4,098 | 56,345 | 5.3% |
| ODD-LOT SHARES SOLD (INCLUDING SHORT SALES) ON NYSE (THOUS.) | 11,694 | 135,779 | 12,931 | 124,543 | 9.0% |
| NYSE BLOCK VOLUME AS A PERCENT OF TOTAL SHARES TRADED | 53.3% | 51.8% | 51.5% | 50.0% | ---- |
| CONTRACTS TRADED (THOUS.) |  |  |  |  |  |
| CBOE OPTIONS | 11,531 | 103,638 | 10,090 | 91,400 | 13.4% |
| AMEX OPTIONS | 2,308 | 24,454 | 2,142 | 25,331 | -3.5% |
| COMMODITY | 12,759 | 117,966 | 11,159 | 114,750 | 2.8% |

## YIELDS

(MONTHLY AVERAGES)

| | SEPTEMBER 1985 | SEPTEMBER 1984 | BASIS POINT CHG 1985-1984 |
|---|---|---|---|
| BOND BUYER INDEX (20 BOND) | 9.27% | 10.10% | (83) |
| CORPORATE BOND YIELDS (MOODY'S) | | | |
| Aaa CORPORATE | 11.07 | 12.66 | (159) |
| Baa CORPORATE | 12.48 | 14.35 | (187) |
| RATIO Aaa CORPS. TO Baa CORPS. | 0.89 | 0.88 | 1 |
| MUNICIPAL BOND YIELDS (MOODY'S) | 9.27 | 10.10 | (83) |

## PRICES

(END OF MONTH)

| | SEPTEMBER 1985 | SEPTEMBER 1984 | % CHAN. Y-T-D 1985-1984 |
|---|---|---|---|
| DOW JONES INDUSTRIALS | 1328.63 | 1206.71 | 10.10% |
| STANDARD & POOR'S 500 | 182.08 | 166.1 | 9.62% |
| NYSE COMPOSITE | 105.19 | 95.77 | 9.84% |
| AMEX MARKET VALUE INDEX | 222.31 | 215.45 | 3.18% |
| VALUE LINE COMPOSITE | 189.01 | 182.44 | 3.60% |
| NASDAQ COMPOSITE | 280.33 | 249.94 | 12.16% |

## UNDERWRITING

| | First Nine Months 1985 | First Nine Months 1984 | First Nine Months %Change 1985-1984 |
|---|---|---|---|
| CORPORATE FINANCING (Gross New Issues-Dollars in Billions) | | | |
| Total | 94.6 | 55.1 | 71.7% |
| Common Stock | 18.1 | 6.6 | 174.2 |
| # of Common Stock Issues | 505 | 427 | 18.3 |
| Preferred Stock | 5.9 | 3.1 | 90.3 |
| # of Preferred Stock Issues | 87 | 52 | 67.3 |
| Corporate Debt | 70.7 | 45.4 | 55.7 |
| # of Corporate Debt Issues | 942 | 221 | 326.2 |
| MUNICIPAL FINANCING (Gross New Issues-Dollars in Millions) | | | |
| Total | 107,656 | 86,234 | 24.8 |
| Notes | 16,875 | 27,647 | (39.0) |
| Bonds | 90,779 | 58,587 | 54.9 |

MARGIN DEBT

| | SEPTEMBER 1985 | SEPTEMBER 1984 | % CHANGE 1985-1984 |
|---|---|---|---|
| MARGIN DEBT OUTSTANDING ($MILS) | $25,330 | $22,800 | 11.1% |
| NET CHANGE IN MARGIN DEBT ($MILS) | 2,530 | 3,040 | -16.8% |
| % OF ACCOUNTS WITH EQUITY UNDER 40% | 12% | 11% | ------ |

## FINANCIAL DATA FOR NYSE FIRMS DOING A PUBLIC BUSINESS
(MILLIONS OF DOLLARS)

| | Second Quarter 1985 | Yr.-To-Date 1985 | Second Quarter 1984 | Yr.-To-Date 1984 | % Change 2nd Q.1985 2nd Q.1984 | Yr.-To-Date % Change 1985 - 1984 |
|---|---|---|---|---|---|---|
| REVENUE | | | | | | |
| SECURITIES COMMISSION INCOME | $1,975 | $4,142 | $1,642 | $3,614 | 20.3% | 14.6% |
| TRADING PROFITS | 2,453 | 4,798 | 1,409 | 3,356 | 74.1 | 43.0 |
| UNDERWRITING | 1,008 | 1,708 | 623 | 1,176 | 61.8 | 45.2 |
| TOTAL REVENUE | 9,216 | 18,186 | 6,900 | 14,344 | 33.6 | 26.8 |
| TOTAL EXPENSES | 8,149 | 16,186 | 6,998 | 13,945 | 16.4 | 16.1 |
| NET INCOME BEFORE TAXES | 1,067 | 2,000 | (98) | 399 | * | 401.3 |
| PERCENT OF FIRMS SHOWING LOSS | 22.1% | 19.6% | 50.4% | 40.8% | --- | --- |

* Infinite Change.

## RECENT INTERESTING READING AND STATISTICAL MATERIAL

| ITEM | DESCRIPTION | SOURCE |
|---|---|---|
| The New York Securities Industry: Its Contribution To New York State and City | The study shows that the New York securities industry has a significant impact on the State and City economies. Among the study's findings: the industry contributes directly and indirectly almost 10% of all taxes collected by the City and State. | SIA<br>$30 members<br>$50 others |
| Management and Professional Earnings in the Securities Industry | Base salary and bonus information on 128 middle management and professional positions, gathered via survey of 46 SIA member firms. Six-part, 350-page report includes comparisons for national versus NYC firms, data at 12/84 versus 4/85, and average, mean and percentile information. | SIA<br>Attn: William Jordan<br>$400 members (1st copy)<br>$1200 others (1st copy)<br>$50 add. copies |
| "Third - Quarter Corporate Finance Rankings" | At the end of the third-quarter, $94.6 billion was raised in all markets, surpassing financings in the comparable period for the past 4 years. Book managers are ranked based on total underwritings (Salomon has the lead) and according to deals handled in various markets and by types of issuer. | Investment Dealers Digest<br>10/7/85 |
| Report to Congress on the Capital Gains Tax Reduction of 1978 | Analysis concludes that the 1978 capital gains tax cut will over time cause the rate of investment, capital stock, national income, labor productivity, and the overall standard of living to be higher than if capital gains taxes were unchanged. However, the study is split on the revenue effect. | Superintendent of Documents<br>U.S. Government Printing Offi<br>Washington, D.C. 20006 |
| "Ranking America's Top Money Managers" | Prudential Insurance Co. is in the lead in this annual ranking of America's 300 largest institutions. Data included are assets under management and portfolio mix. Institutions also ranked by holdings of equities, fixed income and real estate. | Institutional Investor<br>August 1985 |

| | | |
|---|---|---|
| The Stock Exchange Specialist System: An Economic Analysis | Author examines the stock exchange specialists system, with emphasis on the NYSE specialist. Twelve-part paper includes sections on: economies of the specialist unit, specialist portfolio composition, price stabilization, and fairness and efficiency of the specialist system and regulatory response. | Working Paper 85-116<br>Owen Graduate School of Management<br>Vanderbilt University<br>Nashville, Tennessee |
| "Federal Tax Reform and the Regional Character of the Municipal Bond Market" | Article attempts to identify how widely the effects of reform may vary across states. This analysis begins by describing how state laws contribute to the regional character of the bond market. The second section describes the role of demand for bonds by state residents relative to in-state borrowing needs. State tax law and populations in each tax bracket are then analyzed to contrast the effects of current federal law with those of the most recent Administration proposals. The findings suggest that these proposals may have effects on the cost of borrowing that vary widely from one state to another. | Quarterly Review<br>Federal Reserve Bank of New York<br>Autumn 1985 |
| "Mega Mergers--Beginning of the End?" | The first half of 1985 marked a watershed for M&A activity, and perhaps the peak of mega mergers. Author discusses reasons why mergers in coming years are likely to be friendly arrangements. | Financial Analysts Journal<br>July - August 1985 |
| "Sears Roebuck's Struggling Financial Empire" | Article reviews the successes and failures of Sears & Roebuck in attempting to establish the one-stop financial supermarket. | Fortune<br>10/14/85 |
| "Going for Broke in the Gilt Market" | In the U.K. government gilt market, deals are still hand-written into ledgers and the six market-makers keep positions in their heads. This quaint world will change, when fixed commissions and the single capacity system which kept the market gentlemanly and uncompetitive will be swept away. Twenty-nine well-capitalized, U.S.-style primary market-makers, over half foreign-owned, will compete for profits and market share. | Euromoney<br>September 1985 |

Securities Industry Trends

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Produced by the SIA Research Department

1/25/86 A8825-1

Vol. XII, No. 1 January 16, 1986

# Profitability Rises For All Firm Categories In 1H 1985

## Highlights

1. A new and comprehensive data series which only recently became available reveal that retail commissions are a much larger proportion of total commissions than previous estimates indicated. In the 1H 1985, retail commissions are estimated to account for 63% of total commissions and institutional commissions, 37%.

2. Based upon the new data series, discount brokers' market share of 1H 1985 estimated retail commissions was 7%. This suggests that earlier estimates of discounters' market share were probably too high.

3. The industry's annualized after-tax return-on-equity (ROE) for the first nine months of 1985 was 14%. However, since market conditions were extremely strong in 4Q 1985, we estimate that the after-tax ROE for all of 1985 will be about 16%-18%.

4. Profitability in 1H 1985 rose for all firm categories compared with 1984 when ROE for some categories plunged to levels not experienced since 1974. The annualized 1H 1985 after-tax ROEs by firm category were: Large Investment Banks, 21%; N.Y.C. Based Regionals, 17%; Regionals Based Outside N.Y.C., 16%; Discounters, 12%; and National Full-Line, 10%.

5. The Large Investment Banks' proportion of aggregate underwriting revenue rose to 33% from 27% in 1984 while Regionals Based Outside N.Y.C. retained their market shares of commissions and underwriting revenue in 1H 1985.

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## INTRODUCTION

This Trends issue analyzes profitability performance by firm category in 1H 1985 and discusses briefly the industry's 3Q 1985 after-tax return-on-equity (ROE) which just became available. In addition, 1H 1985 estimates of retail commissions are presented, based upon a new and comprehensive data series which only recently was developed from industry sources. Importantly, the new data series reveal that retail commissions are a much larger proportion of total commissions than were previously estimated relying on proxies based on volume.

Unfortunately, data on performance by firm category through the first nine months of 1985 are still not available. This Trends issue furnishes firm category analyses to those who depend on this publication for information on historical trends and to provide the new and more accurate estimate of retail commissions.

Profitability in the 1H 1985 rose for all firm categories compared with 1984 when ROE for some categories plunged to levels not experienced since 1974 (Table 1). In 1H 1985, revenues increased partly because of the more encouraging economic environment in which interest rates declined with indications that rates would remain within a narrow range. In addition, cost containment policies instituted earlier by many firms were becoming effective and contributed to higher profit margins.

### Table 1

### After-Tax Return-on-Equity[1]

| Firm Categories | 1984 | Annualized 1H 1985 | Change in Percentage Points, 1984-Annal. 1H1985 |
|---|---|---|---|
| National Full-Line | (2.4)% [2] | 9.8% | 12.2 |
| Large Investment Banks | 16.8 | 20.8 | 4.0 |
| N.Y.C. Based Regionals | 10.8 | 16.9 | 6.1 |
| Regionals | 3.7 | 15.5 | 11.8 |
| Discounters[3] | (2.4) [2] | 12.3 | 14.7 |
| Industry | 7.2% | 16.4% | 9.2 |

---

[1] For NYSE firms doing a public business.

[2] Pre-tax ROE

[3] NYSE and NASD discounters

( ) Negative

Source: Securities Industry Database

Large Investment Banks (LIBs) were once again the most profitable firm category with an after-tax return-on-equity of 21%. New York City Based Regionals (NYCs) had the second highest after-tax ROE, 17%. The ROEs of the other three firm categories increased the most in 1H 1985 although their levels were still below those of LIBs and NYCs. The 1H 1985 after-tax ROEs of these three categories were: Regionals Based Outside of NYC (REGs), nearly 16%; Discounters (DIS), 12%; and National-Full-Line (NFLs), almost 10%. Compared with 1984, 1H 1985 ROE levels were more uniform and pre-tax income more evenly distributed among the different industry segments.

In the 1H 1985, there were some prominent changes in revenues among the firm categories. For NFLs, trading profits once again exceeded commissions, sales of mutual funds substantially raised revenues, while a drop occurred in their market share of industry underwriting revenue. LIBs' increase in total revenue was below those enjoyed by the other firm categories. Nevertheless, their share of industry underwriting revenue continued to rise. REGs' revenue growth was enhanced by the jump in mutual fund sales while their market shares of commissions and underwriting revenue were retained. NYCs' proportion of industry commissions rose while LIBs' declined because of the plunge in institutional commission rates.

## Firm Categories

## National Full-Line

### Introduction

After suffering losses in 1984, the National Full-Line (NFLs) firm category was profitable in 1H 1985 because of significant increases in revenues from both agency and principal businesses, as well as cost controls implemented earlier. Annualized after-tax ROE was 10% in 1H 1985. Total revenue went up by an annualized 21% compared to expenses which rose by 13% (Table 2). Proximate non-interest revenue[1] climbed 27% while non-interest expense increased only 16%.

Although NFLs' ROE rose in the 1H 1985, this remained the least profitable firm category mainly because of its comparatively low profit margin (Table 3). Their 1H 1985 pre-tax profit margin was less than 6% compared with the overall industry's 11%.

### Revenues

Proximate non-interest revenue rose primarily because of increases in trading profits, commissions and mutual fund sales. These three sources were responsible for 98% of the jump in proximate non-interest revenue.

---

[1] A comparison of proximate non-interest revenue and non-interest expense helps to better understand the reasons for the change in profitability by minimizing the effects of interest rate trends on revenues and expenses.

## Table 2

## National Full-Line Firms
## Revenues and Expenses, 1984 and 1H 1985 1/
(millions of dollars)

| | 1984 | 1H 1985 | |
|---|---|---|---|
| | | Actual | Annualized |
| REVENUES | | | |
| Commissions | $2,936 | $1,781.6 | $3,563.2 |
| Listed equities on an exchange | 2,163 | 1,344.4 | 2,688.8 |
| Listed equities, OTC | 30 | 10.2 | 20.4 |
| Options | 478 | 255.3 | 510.6 |
| All Other | 265 | 171.6 | 343.2 |
| Trading Profits | 3,038 | 2,189.3 | 4,378.6 |
| Market Making - OTC equity | 526 | 374.7 | 749.4 |
| Debt Securities | 2,338 | 1,690.1 | 3,380.2 |
| Options on Nat'l Exchange | 3 | 2.3 | 4.6 |
| All Other | 170 | 122.0 | 244.0 |
| Investment Profits | 110 | 48.2 | 96.4 |
| Underwriting | 1,457 | 814.4 | 1,628.8 |
| Margin Interest | 1,547 | 657.0 | 1,314.0 |
| Mutual Fund Sales | 550 | 579.3 | 1,158.6 |
| Account Supervision | 285 | 179.9 | 359.8 |
| Research | (1) | 0 | 0 |
| Commodities | 608 | 310.8 | 621.6 |
| Other-Related | 1,979 | 1,150.0 | 2,300.0 |
| Other-Unrelated | 560 | 175.7 | 351.4 |
| TOTAL REVENUE | $13,066 | $7,886.1 | $15,772.2 |
| | | | |
| EXPENSES | | | |
| Employment | $5,976 | $3,589.4 | $7,178.8 |
| RR Compensation | 3,246 | 2,023.7 | 4,047.4 |
| Clerical & Administrative | 2,730 | 1,565.7 | 3,131.4 |
| Floor Brokerage & Clearance | 347 | 201.7 | 403.4 |
| Fixed Expense | 2,124 | 1,158.9 | 2,317.8 |
| Communications | 1,066 | 572.8 | 1,145.6 |
| Occupancy & Equipment | 861 | 498.5 | 997.0 |
| EDP Equipment | 197 | 87.6 | 175.2 |
| Promotional Costs | 459 | 219.0 | 438.0 |
| Interest Expense | 2,822 | 1,443.3 | 2,866.6 |
| Errors & Bad Debt | 145 | 79.4 | 158.8 |
| Non-recurring Charges | 10 | 3.2 | 6.4 |
| Partners & Stockholders | 191 | 113.7 | 227.4 |
| Regulatory Fees & Expenses | 49 | 48.4 | 96.8 |
| Other Expenses | 1,063 | 591.8 | 1,183.6 |
| TOTAL EXPENSE | $13,184 | $7,448.7 | $14,897.4 |
| | | | |
| PRE-TAX NET INCOME | $(118) | $437.4 | $874.8 |

---

1/Discrepancies may exist due to rounding.
( ) Negative
Source: Securities Industry Database

## Table 3

## Component Analysis of After-Tax Return on Equity

| Firm Categories | | Profit Margin ($) | x | Asset Turnover ($) | x | Leverage | x | Tax Retention Rate (%) | = | ROE (%) |
|---|---|---|---|---|---|---|---|---|---|---|
| Nat'l Full Line | 1982 | .0881 | | .2681 | | 12.6 | | 54.0% | | 16.1% |
| | 1983 | .0858 | | .2400 | | 13.7 | | 54.0 | | 15.2 |
| | 1984 | (.0083) | | .1787 | | 16.0 | | - | | (2.4)[1] |
| | 1H85[2] | .0555 | | .1875 | | 17.4 | | 54.0 | | 9.8 |
| Lg. Invst. Bks. | 1982 | .1736 | | .1045 | | 30.2 | | 54.0 | | 29.6 |
| | 1983 | .1673 | | .0872 | | 30.0 | | 54.0 | | 23.7 |
| | 1984 | .1144 | | .0837 | | 32.5 | | 54.0 | | 16.8 |
| | 1H85[2] | .1459 | | .0768 | | 34.4 | | 54.0 | | 20.8 |
| New York Based | 1982 | .1403 | | .2257 | | 13.7 | | 54.0 | | 23.4 |
| | 1983 | .1834 | | .2267 | | 12.2 | | 54.0 | | 27.3 |
| | 1984 | .0886 | | .1779 | | 12.7 | | 54.0 | | 10.8 |
| | 1H85[2] | .1245 | | .1881 | | 13.3 | | 54.0 | | 16.9 |
| Regional | 1982 | .1108 | | .3439 | | 9.4 | | 54.0 | | 19.4 |
| | 1983 | .1265 | | .4083 | | 7.8 | | 54.0 | | 21.9 |
| | 1984 | .0259 | | .3235 | | 8.1 | | 54.0 | | 3.7 |
| | 1H85[2] | .0947 | | .3759 | | 8.1 | | 54.0 | | 15.5 |
| Discounters[3] | 1982 | .1360 | | .4932 | | 7.30 | | 54.0 | | 26.4 |
| | 1983 | .1396 | | .5005 | | 6.69 | | 54.0 | | 25.2 |
| | 1984 | .0034 | | .3873 | | 6.48 | | 54.0 | | 0.5 |
| | 1H85[2] | .0721 | | .3610 | | 7.91 | | 54.0 | | 11.1 |
| Industry | 1982 | .1308 | | .1787 | | 17.3 | | 54.0 | | 21.9 |
| | 1983 | .1294 | | .1631 | | 17.3 | | 54.0 | | 19.8 |
| | 1984 | .0515 | | .1348 | | 19.1 | | 54.0 | | 7.2 |
| | 1H85[2] | .1101 | | .1345 | | 20.5 | | 54.0 | | 16.4 |

---

[1] Pre-tax ROE

[2] 1H 1985 data are annualized.

[3] NYSE Discounters

( )Negative

Source: Securities Industry Database

Trading profits climbed by an annualized 44% in the 1H 1985, to $4.4 billion, and accounted for 51% of the rise in proximate non-interest revenue. Improved markets for debt securities and OTC stocks were responsible for almost all of the rise in trading profits. Trading profits in debt securities climbed an annualized 45%, to $3.4 billion, which accounted for nearly 80% of the jump in trading profits. Market-making OTC increased 42%, to $750 million, explaining 17% of the ascent in trading profits.

The 1979 to 1984 compound annual growth rate of trading profits was 28%, compared to the 22% rise for proximate non-interest revenue. As a result, trading profits became NFLs' largest revenue source by 1984 accounting for 23% of total revenue. In 1H 1985, its proportion of total revenue rose to 28%.

Commissions increased an annualized 21% in 1H 1985, to $3.6 billion, and accounted for 24% of the rise in proximate non-interest revenue. Nevertheless, commissions have not grown relative to 1983 as annualized 1H 1985 commissions were still slightly below their 1983 level primarily because of a drop in average commission rates. On the registered stock exchanges, average daily share volume in 1H 1985 was 21% higher than in 1983 and 1H 1985 annualized dollar value of shares traded was 24% higher than in 1983.

The most dramatic change in 1H 1985 NFLs' revenue sources was commissions from mutual fund sales which jumped by an annualized 107% to nearly $1.2 billion. Importantly, this climb raised proximate non-interest revenue by 23%, significantly more than all other revenue sources except trading profits and commissions. Total mutual fund sales soared to $46.2 billion in 1H 1985 compared with $45.8 billion for all of 1984.

Underwriting revenue, NFLs' third largest non-interest revenue source, increased an annualized 12%. However, this rise was considerably below the industry's 26% climb.

The comparatively small 1H 1985 increase in NFLs' underwriting revenue occurred largely because of a decline in their share of corporate debt underwriting volume. In 1984, based on full credit given to book manager, NFLs' proportion of both corporate debt underwriting volume and total corporate underwriting volume was 39%.[2] Also, NFLs' proportion of industry underwriting revenue amounted to 54% in 1984, a relatively large share compared with the 1979-1983 average of 47% (Table 4). One firm, dominant in the fast-growing high-yield bond market, contributed significantly to this category's increase in debt underwriting volume. The magnitude of takeover deals done via public debt offering programs declined in 1H 1985. As a result, the NFLs' share of debt underwriting volume and total corporate underwriting volume fell to 29% and 33%, respectively.

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[2] IDD Information Services, Inc.

## Table 4

### Market Shares of Total Underwriting Revenues by Firm Category

| | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 | 1H 1985 |
|---|---|---|---|---|---|---|---|
| NFL | 43.6% | 47.8% | 45.9% | 54.1% | 45.0% | 53.8% | 47.7% |
| LIB | 25.6 | 25.0 | 23.6 | 24.2 | 29.7 | 27.1 | 32.6 |
| REG | NA | NA | NA | 16.0 | 17.8 | 14.6 | 14.3 |
| NYC | NA | NA | NA | 3.1 | 2.5 | 1.3 | 1.6 |
| Other | NA | NA | NA | 2.6 | 5.0 | 3.2 | 3.9 |
| | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% |

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NA Not available
Source: Securities Industry Database

### Expenses

NFLs' expenses rose modestly in the 1H 1985 as the impact of earlier cost control policies in 1984 was felt. Most of the increases in expenses resulted from higher employment costs related to increased production. Overall, annualized 1H 1985 expenses rose only 13% while revenues increased by 21%.

Higher employment costs were responsible for 73% of the 1H 1985 rise in non-interest expense. RR compensation increased 25% because of increased production and accounted for 49% of the rise in non-interest expense. Average RR employment rose to 48,000 in the 1H 1985 from 46,000 in 1984, a 4% increase. Clerical and administrative employee expenses went up by an annualized 15%.

The positive results of the cost controls policies instituted in 1984 were clearly seen in the very modest 9% 1H 1985 annualized increase in so-called fixed expense. The compound annual increase in such expenses was 29% from 1979-1984. On an annualized basis, EDP equipment costs fell by 11%, communications expense rose less than 8% and occupancy & equipment increased 16%.

## Large Investment Banks[3]

### Introduction

Large Investment Banks (LIBs) were once again the most profitable firm category in 1H 1985 with an annualized after-tax ROE of 21%. Annualized 1H 1985 total revenue rose a modest 11% while expenses went up by 7% (Table 5). As a result, annualized pre-tax profit margin improved to almost 15%.

### Revenues

Three sources were responsible for almost all of the growth in annualized 1H 1985 proximate non-interest revenue: commodities; underwriting; and trading profits.[4] Commissions and mutual fund sales contributed very little to the increase.

Trading profits were the largest revenue source for LIBs. However, despite very favorable 1H 1985 market conditions, such revenue rose only by a reported 7%. This occurred because of the reported small rise in trading profits from debt securities and the drop in "other."[5] As a result, trading profits accounted for 19% of LIBs' 1H 1985 growth in proximate non-interest revenue.

---

[3] Lehman Brothers, an LIB firm, was acquired by Shearson/American Express, an NFL firm, in 1984. Lehman Brothers essentially stopped doing business in 2Q 1984 and its proportions of the LIBs' 1984 total revenue, total expense and income were insignificant in that year. Consequently, the inclusion of Lehman Brothers in the LIBs' 1984 data does not affect this category's 1H 1985 analysis relative to 1984.

[4] We believe that trading profits for LIBs may have been understated while the reported climb in commodities revenue may be overstated. Some of the revenue reported under commodities may belong in trading profits.

[5] LIBs' trading profits in debt securities increased a reported 10%, significantly below the rest-of-the industry's 44% climb. The rest-of-the industry's 1H 1985 percent changes in long positions and short positions were similar to those for LIBs. So this does not explain the "weak" relative rise in trading profits for the LIB category.

Commodities revenue climbed by a reported 550% which accounted for 29% of the 1H 1985 rise in proximate non-interest revenue.

We believe that there may be some reporting problems for this firm category. For the rest-of-the industry, commodities revenue rose only 2% while trading profits jumped by 41%. We have been in touch with the self-regulators about these concerns.

## Table 5

## Large Investment Banks
## Revenues and Expenses, 1984 and 1H 1985 [1]
(millions of dollars)

| | 1984 | 1H 1985 | |
|---|---|---|---|
| | | Actual | Annualized |
| REVENUES | | | |
| Commissions | $1,068 | $573.3 | $1146.6 |
| Listed equities on an exchange | 915 | 496.0 | 992.0 |
| Listed equities, OTC | 2 | 1.5 | 3.0 |
| Options | 70 | 38.3 | 76.6 |
| All Other | 81 | 37.5 | 75.0 |
| Trading Profits | 3,397 | 1,822.5 | 3,644.0 |
| Market Making - OTC equity | 119 | 85.0 | 170.0 |
| Debt Securities | 2,702 | 1,480.0 | 2,960.0 |
| Options on Nat'l Exchange | (3) | 54.2 | 108.4 |
| All Other | 580 | 202.9 | 405.8 |
| Investment Profits | 364 | 219.7 | 439.4 |
| Underwriting | 734 | 557.6 | 1,115.2 |
| Margin Interest | 385 | 172.8 | 345.6 |
| Mutual Fund Sales | 11 | 12.3 | 24.6 |
| Account Supervision | 111 | 62.7 | 125.4 |
| Research | 0[2] | .2 | .4 |
| Commodities | 65 | 212.3 | 424.6 |
| Other-Related | 3,327 | 1,603.0 | 3,206.0 |
| Other-Unrelated | 640 | 386.6 | 773.2 |
| TOTAL REVENUE | $10,103 | $5,622.5 | $11,245.0 |
| EXPENSES | | | |
| Employment | $1,926 | $1,155.1 | $2,310.2 |
| RR Compensation | 786 | 500.5 | 1001.0 |
| Clerical & Administrative | 1,140 | 654.6 | 1,309.2 |
| Floor Brokerage & Clearance | 216 | 108.2 | 216.4 |
| Fixed Expense | 605 | 348.5 | 697.0 |
| Communications | 261 | 136.7 | 273.4 |
| Occupancy & Equipment | 259 | 150.3 | 300.6 |
| EDP Equipment | 85 | 61.5 | 123.0 |
| Promotional Costs | 140 | 75.3 | 150.6 |
| Interest Expense | 5,318 | 2,595.9 | 5,191.8 |
| Errors & Bad Debt | 21 | 12.6 | 25.2 |
| Non-recurring Charges | 0[2] | 0.0 | 0.0 |
| Partners & Stockholders | 301 | 197.6 | 395.2 |
| Regulatory Fees & Expenses | 28 | 15.9 | 31.8 |
| Other Expenses | 394 | 293.1 | 586.2 |
| TOTAL EXPENSE | $8,948 | $4,802.2 | $9,604.4 |
| PRE-TAX NET INCOME | $1,155 | $820.4 | $1,640.8 |

---

[1] Discrepancies may exist due to rounding.

[2] Less than $500,000.

( ) Negative
Source: Securities Industry Database

LIBs' underwriting revenue climbed an annualized 52% in 1H 1985 which raised proximate non-interest revenue by nearly 29%. Their proportion of industry underwriting revenue rose to nearly 33% in 1H 1985 from 27% in 1984. LIBs' share of total corporate underwriting volume, based upon full credit given to the book manager, was almost 63% in 1H 1985 compared to less than 58% in 1984.[6] This rise was in both debt and equity offerings. Their proportion of long-term municipal underwriting volume, based upon full credit given to the lead manager, remained at about 23% in 1H 1985.[7]

Commissions, LIBs' second largest non-interest revenue source, rose by an annualized 7% in 1H 1985 largely because of a decrease in the average institutional commission rate. Of LIBs' total revenue, commissions were only 10% in 1H 1985.

Revenue from mutual fund sales increased an annualized 124%. However, such revenues raised proximate non-interest revenue by only 1%. Mutual funds are basically a retail product and LIBs emphasize institutional and principal businesses.

## Expenses

LIBs' non-interest expense rose an annualized 22% in 1H 1985, significanlty more than rest-of-the industry's 14% increase. Higher expense levels for employment, other, partners & stockholders and so-called fixed expense explain this category's climb in non-interest expense.

Higher employment costs accounted for 49% of the rise in 1H 1985 annualized non-interest expense. The rise in RR compensation explained almost 27% of this increase while higher clerical and administrative employee expense was responsible for 22%. Most of this resulted because of increased productivity as average total employment rose by only 3%.

So-called fixed expense increased 15% which was responsible for 12% of the rise in annualized non-interest expense. Communications expense went up by 5%, occupancy & equipment rose by 16% but EDP equipment costs climbed by a dramatic 45%. Apparently, LIBs' EDP equipment costs rose significantly to increase capacity and change systems to handle higher volume, especially in the fixed income area.[8]

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[6] IDD Information Services, Inc.

[7] Public Securities Association, "The Municipal Securities Market First Half of 1985."

[8] Higher "other" expenses accounted for 25% of 1H 1985 annualized rise in LIBs' non-interest expense while the rise in partners & stockholders costs were responsible for 12%.

## Regionals

### Introduction

Regionals' (REGs') annualized after-tax ROE rose significantly in the 1H 1985 to almost 16% after dropping to 4% in 1984. This occurred as retail agency business improved and revenue from principal activities increased. In addition, expenses were constrained as REG firms' cost containment policies were very effective.

REGs' annualized 1H 1985 total revenue increased 18% while total expense went up by just 9% (Table 6). Proximate non-interest revenue climbed 27% and non-interest expense rose 13%. As a result, significant 1H 1985 increases took place in their profit margin which rose to more than 9% from less than 3% in 1984.

### Revenues

The four revenue sources which were responsible for almost all of the industry's 1H 1985 growth in proximate non-interest revenue also accounted for most of the improvement in REGs' proximate non-interest revenue. Increases in trading profits, commissions, mutual fund sales and underwriting explain 93% of the 1H 1985 rise in proximate non-interest revenue.

Trading profits climbed an annualized 37% in 1H 1985 and were responsible for 30% of the rise in proximate non-interest revenue. The decline in interest rates resulted in trading profits in debt securities increasing by an annualized 34%. The NASDAQ Composite Index rose to 296 at the end of 1H 1985, a 20% increase from year-end 1984, which aided in a 42% climb in OTC market-making profits.

Commissions rose by nearly 15%, to $1.3 billion, because of the improvement in retail agency business. This accounted for 26% of the increase in proximate non-interest revenue.

REGs benefited from investors' increased interest in equities and long-term government bond mutual funds. Revenue from mutual fund sales soared by an annualized 93%, to $310 million, which accounted for 23% of the rise in proximate non-interest revenue. This 1H 1985 revenue climb was larger in absolute terms than from all other revenue sources except trading profits and commissions. In fact, the annualized rise in revenue from mutual fund sales, $149 million, was nearly equal to that from commissions, $170 million.

During the 1H 1985, underwriting revenue for REG firms was clearly boosted by the boom in municipal volume which increased at a pace exceeding the 1984 record. Offsetting this favorable development has been the increased proportion of corporate securities not distributed through syndicates or using smaller syndicates.

## Table 6

### Regional Firms
### Revenues and Expenses, 1984 and 1H 1985 1/
(millions of dollars)

| | 1984 | 1H 1985 | |
|---|---|---|---|
| | | Actual | Annualized |
| REVENUES | | | |
| Commissions | $1,176 | $673.1 | $1,346.2 |
| Listed equities on an exchange | 729 | 416.0 | 832.0 |
| Listed equities, OTC | 12 | 7.0 | 14.0 |
| Options | 129 | 69.5 | 139.0 |
| All Other | 306 | 180.6 | 361.2 |
| Trading Profits | 530 | 362.8 | 725.6 |
| Market Making - OTC equity | 174 | 123.4 | 246.8 |
| Debt Securities | 296 | 198.9 | 397.8 |
| Options on Nat'l Exchange | 1 | 0.3 | 0.6 |
| All Other | 63 | 40.8 | 81.6 |
| Investment Profits | 17 | 29.5 | 59.0 |
| Underwriting | 396 | 244.7 | 489.4 |
| Margin Interest | 400 | 140.5 | 281.0 |
| Mutual Fund Sales | 161 | 155.0 | 310.0 |
| Account Supervision | 44 | 27.2 | 54.4 |
| Research | 6 | 2.2 | 4.4 |
| Commodities | 41 | 19.1 | 38.2 |
| Other-Related | 410 | 222.4 | 444.8 |
| Other-Unrelated | 58 | 28.5 | 57.0 |
| TOTAL REVENUE | $3,240 | $1,905.0 | $3,810.0 |
| EXPENSES | | | |
| Employment | $1,452 | $851.5 | $1,703.0 |
| RR Compensation | 847 | 522.1 | 1,044.2 |
| Clerical & Administrative | 605 | 329.4 | 658.8 |
| Floor Brokerage & Clearance | 166 | 95.6 | 191.2 |
| Fixed Expense | 512 | 267.9 | 535.8 |
| Communications | 262 | 129.8 | 259.6 |
| Occupancy & Equipment | 197 | 106.3 | 212.6 |
| EDP Equipment | 55 | 31.8 | 63.6 |
| Promotional Costs | 98 | 49.0 | 98.0 |
| Interest Expense | 424 | 178.9 | 357.8 |
| Errors & Bad Debt | 23 | 11.3 | 22.6 |
| Non-recurring Charges | 12 | 1.9 | 3.8 |
| Partners & Stockholders | 221 | 132.7 | 265.4 |
| Regulatory Fees & Expenses | 29 | 15.9 | 31.8 |
| Other Expenses | 215 | 119.4 | 238.8 |
| TOTAL EXPENSE | $3,155 | $1,724.6 | $3,449.2 |
| PRE-TAX NET INCOME | $84 | $130.4 | $360.8 |

---

1/Discrepancies may exist due to rounding.
Source: Securities Industry Database

### Expenses

Non-interest expense rose relatively less for REGs than the rest-of-the industry. For example, the difference between the increase in proximate non-interest revenue and non-interest expense was 14 percentage points for REGs compared with 8 percentage points for the rest-of-the industry.

Employment expense rose with higher production and was responsible for 70% of the rise in non-interest expense. RR compensation went up by 23% despite the average number of RRs declining 2%, to 15,130 from 15,465 in 1984. Excluding RRs, the number of other employees decreased 4%, to 19,925 from 20,715 in 1984.

At 5%, REGs' annualized 1H 1985 rise in so-called fixed expense was lower than any other firm category. Communications decreased an annualized 1%, occupancy & equipnent expenses increased 8% and EDP costs rose 16%.. For the rest-of-the industry, so-called fixed expense went up 11%.

## New York City Regionals

### Introduction

NYC regional firms' (NYCs') annualized after-tax ROE rose to 17% in the 1H 1985 after dropping to 11% in 1984. While total revenue increased an annualized 17%, total expense rose 13% (Table 7). NYCs' revenue growth was as strong as the rest-of-the industry, however, their expenses rose more substantially. Unlike most of the other firm categories, NYC regionals apparently did not institute cost containment policies if increased expenditures on technology are any guide to overall policy. Nevertheless, this was the second most profitable firm category which has been the general trend since 1974.

### Revenues

The sources spurring NYCs' 1H 1985 revenue growth differed somwhat from those that contributed to the overall industry's rise. Three revenue sources - commissions, trading profits and account supervision were responsible for almost all of the 1H 1985 annualized growth in proximate non-interest revenue. Unlike the rest-of-the industry, commissions and account supervision were more important while mutual fund sales and underwriting were less important. Compared to the rest-of-the industry, NYC regionals are more orientated towards agency business, both institutional and retail, as well as money management.

Commissions climbed an annualized 28% in the 1H 1985, significantly higher than the rest-of-the industry's increase of less than 16%. Commission growth was responsible for 64% of the rise in NYCs proximate non-interest revenue.

## Table 7

## New York Regional Firms
## Revenues and Expenses, 1984 and 1H 1985 [1]
(millions of dollars)

| | 1984 | 1H 1985 | |
|---|---|---|---|
| | | Actual | Annualized |
| REVENUES | | | |
| Commissions | $681 | $435.7 | $871.4 |
| Listed equities on an exchange | 508 | 323.8 | 647.6 |
| Listed equities, OTC | 18 | 14.0 | 28.0 |
| Options | 47 | 30.6 | 61.2 |
| All Other | 108 | 67.2 | 134.4 |
| Trading Profits | 206 | 168.4 | 336.8 |
| Market Making - OTC equity | 32 | 30.1 | 60.2 |
| Debt Securities | 113 | 89.7 | 179.4 |
| Options on Nat'l Exchange | 19 | 3.7 | 7.4 |
| All Other | 42 | 44.9 | 89.8 |
| Investment Profits | 63 | 20.1 | 40.2 |
| Underwriting | 34 | 28.0 | 56.0 |
| Margin Interest | 230 | 96.9 | 193.8 |
| Mutual Fund Sales | 9 | 12.9 | 25.8 |
| Account Supervision | 115 | 74.8 | 149.6 |
| Research | 3 | 1.0 | 2.0 |
| Commodities | 17 | 7.5 | 15.0 |
| Other-Related | 241 | 138.3 | 276.6 |
| Other-Unrelated | 107 | 17.8 | 35.6 |
| TOTAL REVENUE | $1,705 | $1,001.5 | $2,003.0 |
| EXPENSES | | | |
| Employment | $586 | $368.2 | $736.4 |
| RR Compensation | 264 | 178.1 | 356.2 |
| Clerical & Administrative | 322 | 190.1 | 380.2 |
| Floor Brokerage & Clearance | 140 | 89.6 | 179.2 |
| Fixed Expense | 201 | 121.6 | 243.2 |
| Communications | 86 | 54.0 | 108.0 |
| Occupancy & Equipment | 86 | 52.6 | 105.2 |
| EDP Equipment | 27 | 15.0 | 30.0 |
| Promotional Costs | 35 | 19.9 | 39.8 |
| Interest Expense | 347 | 128.0 | 256.0 |
| Errors & Bad Debt | 9 | 6.4 | 12.8 |
| Non-recurring Charges | 4 | 3.4 | 6.8 |
| Partners & Stockholders | 84 | 43.3 | 86.6 |
| Regulatory Fees & Expenses | 13 | 8.9 | 17.8 |
| Other Expenses | 137 | 75.6 | 151.2 |
| TOTAL EXPENSE | $1,554 | $876.8 | $1,753.6 |
| PRE-TAX NET INCOME | $151 | $124.7 | $249.4 |

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[1] Discrepancies may exist due to rounding.

Source: Securities Industry Database

NYC trading profits rose an annualized 63% in 1H 1985, significantly higher than the 26% increase experienced by the rest-of-the industry. Like the rest-of-the industry, trading profits in debt securities was responsible for the most significant increase in trading profits, 51%. Unlike the rest-of-the industry, "other" accounted for the second largest rise.

Fees for supervision and advisory services were much more important to NYCs' 1H 1985 annualized growth than for other industry segments. NYCs are relatively more heavily involved in money management than the rest-of-the industry. In 1H 1985, such fees raised NYCs annualized proximate non-interest revenue by 12% compared to less than 2% for the rest-of-the industry.

Underwriting revenue increased an annualized 64% in 1H 1985, to $56 million, raising proximate non-interest revenue by 7%. For NYC regionals, underwriting is not as significant a revenue source as for the rest-of-the industry, accounting for about 3% of proximate non-interest revenue in both 1984 and 1H 1985.

## Expenses

Expenses increased more for NYC regionals in 1H 1985 than the rest-of-the industry largely because of revenue growth. NYCs' profit margin rose to 12% from about 9% in 1984, the second highest among the firm categories in both periods. Nevertheless, NYCs did not institute cost containment programs as most of the firm categories had to do. So-called fixed expense climbed significantly faster for NYCs while they rose relatively modestly for the rest-of-the industry.

Employment expense (RR and clerical & administrative) increased an annualized 26% largely because of higher production and accounted for 52% of the 1H 1985 rise in non-interest expense. Total employment increased less than 7% in 1H 1985, to 12,545 from 11,715 in 1984.

NYCs so-called fixed expense climbed an annualized 21% in the 1H 1985 compared to a modest 9% for the rest-of-the industry. Nevertheless, so-called fixed expense was a smaller proportion of 1H 1985 NYCs' non-interest expense, 14%, than for the rest-of-the industry, nearly 18%. Communications expense climbed by 26% which accounted for 52% of the 1H 1985 jump in so-called fixed expense. From 1982 to 1984, the compound annual growth rate for communications was only 6%. Apparently, NYCs increased their 1H 1985 communications expenditure by incorporating new technology for competitive reasons. Occupancy & equipment also rose significantly, 22%, and was responsible for 45% of the higher 1H 1985 so-called fixed expense. Since 1982, occupancy & equipment costs have been increasing at a rapid 31% compound annual rate reflecting higher rental costs and expanding facilities.

## Discounters

## Introduction

Included in this analysis of discounters (DIS) 1H 1985 profitability performance are members of both the NYSE and NASD. In 1H 1985, discounters who were sole members of NASD accounted for: 23% of revenues and expenses; 21% of commissions; and 26% of pre-tax income of all discounters.

DIS returned to profitability in 1H 1985 as retail investors' interest in equities improved because of more favorable market conditions. In 1H 1985, NYSE average daily share volume climbed 18% and the NYSE Composite Index rose 15%. DIS' total revenue increased an annualized 19% while total expense went up by less than 10%. Proximate non-interest revenue climbed 25% and non-interest expense rose less than 11%. As a result, annualized 1H 1985 after-tax ROE rose to 12% compared with a 1984 pre-tax ROE of (2)%. Still, DIS' 1H 1985 profitability was low relative to most other firm categories and compared with an after-tax ROE of 23% in 1982 and 22% in 1983.

## Revenues[9]

DIS' non-interest revenue was essentially derived from commissions which accounted for 87% of 1H 1985 proximate non-interest revenue. For the rest-of-the industry, commissions amounted to 29% of proximate non-interest revenue.

DIS commissions climbed by an annualized 23%, significantly greater than the rest-of-the industry's 16% increase. This occurred because retail activity rose substantially in 1H 1985 from its depressed 1984 level. Also, retail commission rates were not under the same severe price pressures as institutional rates. The climb in commissions accounted for 83% of the 1H 1985 increase in DIS proximate non-interest revenue.

## Market Share

DIS' 1H 1985 market share of estimated retail commissions was determined based upon our new data series which generates excellent information on volume from the largest institutions. These new data yield more accurate estimates of retail commissions than prior methods utilized by various analysts. Previously, all analysts were forced to estimate retail commissions' proportion of total commissions by utilizing various data on different market proxies. Additional weaknesses were that it did not allow for changes in average retail and institutional commission rates over time.

The new estimating method relies on comprehensive share volume data from broker/dealers and includes share volume data from the largest institutions on the NYSE, AMEX, and NASDAQ. These new data series first became available to SIA in May 1985. Professional institution share volume is obtained from a comprehensive universe of reporting broker-dealers (1,084) and participating institutions (4,980). Share volume is reported for all deliver-versus-payment

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[9] The analysis of revenues and expenses is based solely upon NYSE DIS data.

(DVP) transactions and receive-versus-payment (RVP) transactions. Member trading share volume is supplied separately in weekly reports by the NYSE and AMEX. Retail share volume is obtained as a residual.[10]

NYSE and AMEX retail share volume along with the estimated average retail commission rate yields an estimate for retail commissions on these exchanges which are combined to estimate industry retail commissions. The same approach is used to estimate institutional commissions on these exchanges.

The 1H 1985 proportion of publicly traded share volume from retail accounts on the NYSE was estimated at 32% and 53% on AMEX.[11] Consequently, professional institution's proportion of publicly traded share volume on the NYSE was estimated at 68% and 47% on AMEX. The average retail commission in the 1H 1985 was estimated to be $.27 per share and the average professional institution commission was estimated at $.08 per share. These averages were based upon an informal survey of securities firms and securities analysts.

Estimates from this analysis show that of total 1H 1985 commissions, 63% was retail and 37% institutional. As a result, DIS' market share of 1H 1985 retail commissions was 7% (Table 8). Comparisons with prior years are inappropriate since the new data series only became available in the 2Q 1985.

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[10] For a more detailed analysis of these new data series see Schaefer, Jeffrey, "Introducing SIA's Investor Activity Report," Trends, July 31, 1985.

[11] On the NYSE and AMEX, retail share volumes' preliminary proportions of publicly traded share volumes (excludes member trading) averaged 39% and 64%, respectively, from May to October 1985. The monthly fluctuations on both exchanges were within a fairly narrow range. These averages were used to estimate retail share volume for the 1H 1985. Each of these averages was lowered 17% because some professional institution share volume is not reported in DVP or RVP transactions. This 17% adjustment was determined based upon input from equity professionals. The proportion of publicly traded share volume from professional institutions was 68% and 47% on the NYSE and AMEX, respectively after adjustment. Combined with member trading as principals, institutions and brokers accounted for 76% of volume on the NYSE and AMEX.

## Table 8

## NYSE and NASD Discounters' Market Share, 1H 1985
(millions of dollars)

| | Actual Dollars |
|---|---|
| Industry Commissions | $4,139.2 |
| Estimated Retail Commissions | 2,611.8 |
| Discounters' Commissions | 182.2 |
| Discounters' Market Share of Retail Commissions | 7.0% |
| Industry Gross Revenue | $18,178.1 |
| Discounters' Gross Revenue | 274.3 |
| Discounters' Market Share of Gross Revenue | 1.5% |

### Expenses

DIS non-interest expense rose by an annualized 11% in 1H 1985. Employment expense rose less for DIS, 16%, than NFLs, 20%, but about the same as REGs, 17%. This occurred even though average employment rose slightly more for DIS, 3%, than for NFLs, 2%, and REGs, (2)%.

DIS so-called fixed expense increased an annualized 15%, significantly more than for NFLs, 9%, and REGs, 5%. Furthermore, each of the three items in so-called fixed expense rose more for DIS than for these other categories. In 1H 1985, DIS communications expense increased 10%, occupancy & equipment 19% and EDP equipment costs 17%. The 1982 to 1H 1985 annualized compound annual growth rate for DIS so-called fixed expense has been a rapid 30%, led by occupancy & equipment, 41%, communications, 27%, and EDP equipment costs, 18%.

DIS continued to spend more for promotional activities than the NFLs or REGs. In 1H 1985, such costs climbed an annualized 32% compared with NFL firms' 5% decrease while REG firms' expenditure remained at about the 1984 level. Promotional expense's 1982 to 1H 1985 annualized compound annual growth rate was 32% for DIS compared with 10% for NFLs and 9% for REGs.

## Industry's 3Q 1985 Profitability Performance

Profitability fell in 3Q 1985 as annualized after-tax ROE was 10% compared with 16% for 1H 1985. This drop occurred largely because interest rates reached their troughs toward the end of 2Q

1985 and rose modestly in 3Q 1985. Total revenue decreased by an annualized 3%, while expenses increased by about 1%.

The lower 3Q 1985 revenue level occurred entirely because of the drop in annualized revenue from three sources: trading profits, $1.2 billion; commissions, $818 million; and investment profits, $603 million. On the expense side, annualized costs went up most substantially for: employment, $243 million; so-called fix expense, $188 million; and non-recurring charges, $102 million.

The 3Q 1985 drop in profitability reduced the industry's annualized after-tax ROE for the first nine months of 1985 to 14%. However, market conditions were extremely strong in the 4Q 1985 because of declining intermediate and long-term interest rates and optimistic expectations that rates could continue to fall due to the G-5 agreement, passage of the Gramm-Rudman amendment and OPEC's new production policy. As a result, the industry's after-tax ROE for all of 1985 should rise to about 16%-18%. This would be a significant improvement compared with 1984 when after-tax ROE was 7%, the least profitable year since 1977.

Ira Epstein
Assistant Director
of Research

VOLUME

| | NOVEMBER 1985 | YEAR-TO-DATE 1985 | NOVEMBER 1984 | YEAR-TO-DATE 1984 | % CHAN. Y-T-D 1985-1984 |
|---|---|---|---|---|---|
| AVERAGE DAILY SHARE VOLUME ON | | | | | |
| NYSE (MILS.)* | 122.3 | 107.0 | 83.7 | 91.3 | 17.1% |
| AMEX (MILS.)* | 9.1 | 8.0 | 6.0 | 6.0 | 33.6% |
| NASDAQ (MILS.)* | 92.0 | 79.2 | 58.2 | 59.5 | 33.2% |
| REGIONAL EXCHANGE (MILS.)* | N/A | N/A | 14.4 | 14.3 | N/A |
| DOLLAR VALUE OF SHARES TRADED ON | | | | | |
| NYSE (MILS.) | $86,772 | $867,706 | $57,025 | $708,2[illegible] | 22.5% |
| AMEX (MILS.) | 2,255 | 22,869 | 1,761 | 18,808 | 21.6% |
| ODD-LOT SHARES PURCHASED ON NYSE (THOUS.) | 5,954 | 71,092 | 4,515 | 65,771 | 8.1% |
| ODD-LOT SHARES SOLD (INCLUDING SHORT SALES) ON NYSE (THOUS.) | 15,483 | 165,039 | 13.295 | 152,611 | 8.1% |
| NYSE BLOCK VOLUME AS A PERCENT OF TOTAL SHARES TRADED | 51.6% | 51.9% | 49.2% | 50.0% | ---- |
| CONTRACTS TRADED (THOUS.) | | | | | |
| CBOE OPTIONS | 13,964 | 132,562 | 10,350 | 11[illegible].451 | 16.8% |
| AMEX OPTIONS | 3,386 | 31,914 | 2,061 | 30,353 | 5.1% |
| COMMODITY | 14,022 | 145,236 | 12,694 | 139,608 | 4.0% |

*MONTHLY AVERAGE
N/A - DATA NOT AVAILABLE

## YIELDS

(MONTHLY AVERAGES)

| | DECEMBER 1985 | DECEMBER 1984 | BASIS POINT CHG 1985-1984 |
|---|---|---|---|
| BOND BUYER INDEX (20 BOND) | 8.43% | 9.90% | (147) |
| CORPORATE BOND YIELDS (MOODY'S) | | | |
| Aaa CORPORATE | 10.16 | 12.71 | (255) |
| Baa CORPORATE | 11.58 | 14.19 | (261) |
| RATIO Aaa CORPS. TO Baa CORPS. | 0.88 | 0.90 | (2) |
| MUNICIPAL BOND YIELDS (MOODY'S) | 8.43 | 10.10 | (167) |

## PRICES

(END OF MONTH)

| | DECEMBER 1985 | DECEMBER 1984 | % CHAN. Y-T-D 1985-1984 |
|---|---|---|---|
| DOW JONES INDUSTRIALS | 1546.67 | 1211.57 | 27.66% |
| STANDARD & POOR'S 500 | 211.28 | 167.24 | 26.33% |
| NYSE COMPOSITE | 121.58 | 96.38 | 26.15% |
| AMEX MARKET VALUE INDEX | 246.13 | 204.26 | 20.50% |
| VALUE LINE COMPOSITE | 214.86 | 177.98 | 20.72% |
| NASDAQ COMPOSITE | 324.93 | 247.35 | 31.36% |

## UNDERWRITING

| | FULL YEAR 1985 | FULL YEAR 1984 | % CHANGE FY 1985 - FY 1984 |
|---|---|---|---|
| CORPORATE FINANCING (Gross New Issues– Billions) | | | |
| Total | 138.5 | 82.4 | 68.1% |
| Common Stock | 24.8 | 9.2 | 169.6 |
| # of Common Stock Issues | 746 | 563 | 32.5 |
| Preferred Stock | 8.6 | 3.9 | 120.5 |
| # of Preferred Stock Issues | 131 | 70 | 87.1 |
| Corporate Debt | 105.1 | 69.3 | 51.7 |
| # of Corporate Debt Issues | 1,347 | 786 | 71.4 |
| MUNICIPAL FINANCING (Gross New Issues – Millions) | | | |
| Total | $180,380 | $132,950 | 35.7% |
| Notes | 18,860 | 31,068 | (39.3) |
| Bonds | 161,520 | 101,882 | 58.5 |

MARGIN DEBT

| | NOVEMBER 1985 | NOVEMBER 1984 | % CHANGE 1985-1984 |
|---|---|---|---|
| MARGIN DEBT OUTSTANDING ($MILS) | 26,640 | 22,350 | 19.2% |
| NET CHANGE IN MARGIN DEBT ($MILS) | 4,290 | 560 | 666.1% |
| % OF ACCOUNTS WITH EQUITY UNDER 40% | 11% | 11% | ----- |

## FINANCIAL DATA FOR NYSE FIRMS DOING A PUBLIC BUSINESS
(MILLIONS OF DOLLARS)

| | Third Quarter 1985 | Yr. -To-Date 1985 | First Quarter 1984 | Yr. -To-Date 1984 | % Change 3rd Q. 1985 3rd Q. 1984 | Yr. -To-Date % Change 1985 - 1984 |
|---|---|---|---|---|---|---|
| REVENUE | | | | | | |
| SECURITIES COMMISSION INCOME | $1,865 | $6,012 | $1,766 | $5,387 | 5.6% | 11.6% |
| TRADING PROFITS | 2,100 | 6,913 | 2,005 | 5,134 | 4.7 | 34.7 |
| UNDERWRITING | 1,013 | 2,720 | 659 | 1,836 | 53.7 | 48.1 |
| TOTAL REVENUE | 8,815 | 27,024 | 8,324 | 22,698 | 5.9 | 19.1 |
| TOTAL EXPENSES | 8,144 | 24,392 | 7,632 | 21,594 | 6.7 | 13.0 |
| NET INCOME BEFORE TAXES | 671 | 2,632 | 692 | 1,104 | (3.0) | 138.4 |
| PERCENT OF FIRMS SHOWING LOSS | 32.4% | NA | 30.9% | NA | --- | --- |

# RECENT INTERESTING READING AND STATISTICAL MATERIAL

| Item | Description | Source |
|---|---|---|
| Survey of Legal and Compliance Departments in the Securities Industry | SIA's inaugural survey on legal and compliance departments. In addition to data on salaries and bonuses, this survey will present information on how compliance departments operate - - their roles within the firm and their philosophies. Common denominators and particularly effective methods or styles will be highlighted. Scheduled to be released in January. | Orders being taken by SIA Publications Dept.<br>Non-participating firms: $275<br>Non-member firms: $550 |
| "RR Perspectives '85: Retail Registered Representatives and the Securities Industry" | Results (Part 1) of RR survey focusing on overall picture of "typical" broker. For example, the typical broker has 314 accounts in his book, follows 24 companies closely, and makes 17 cold calls a day. | Registered Representative<br>December 1985 |
| Committee Report on "Tax Reform Act of 1985" | Contains background, summary, revenue and budget effects, explanations of all provisions and dissenting views. | Bureau of National Affair's Customer Service Center<br>9435 Key West Ave.<br>Rockville, MD 20850<br>2 - Parts, $15 each |
| "The Expenditure Tax Option" | Concern over the impact of tax reform on the competitiveness of the U.S. in world markets, insistence on revenue-neutral tax reform, and the need for deficit reduction have placed new emphasis on consumption or expenditure tax options. Article reviews four bills based on these concepts, including Roth's business transfer tax. | The Journal<br>The Institute for Socioeconomic Studies<br>Quarterly publication |
| "1985 Euro-Bond Ranking" | Top 25 book managers ranked. Credit Swisse First Boston holds first place in Eurobond debt offerings, accounting for $19.3 in book-run deals. | Investment Dealer's Digest<br>1/6/86 |

| | | |
|---|---|---|
| "Tax Reform & Financial Markets"<br>"Tax Reform, Interest Rates and Capital Allocation" | Two working papers reviewing the impact of Treasury I and II, Bradley-Gephardt and Kemp-Kasten. The first paper compares and contrasts the likely impact of each of these four proposals on interest rates for taxable and tax-exempt issues, flows to different securities, and stock prices. The second paper reviews the proposals' effects on the level of interest rates and the allocation of capital among nonresidential capital, rental housing and owner occupied housing. | Working Paper no. 1707 & 1708<br>National Bureau of Economic Research<br>1050 Massachusetts Ave.<br>Cambridge, MA 02138 |
| "Deals of the year - hits, misses and curiosities" | Summary thoughts on all three types of deals, from company as well as banker. Example "hit": IPO of Fireman's Fund Corp. Example "miss": 3 debt offerings by Kmart Corp. | Institutional Investor<br>December 1985 |
| "Rating Advisers" | Summary of the Hulbert Financial Digest's annual report on investment advisers. 73 newsletters ranked by change in portfolio. | Barron's<br>1/13/86 |
| "Where to Invest in 1986" | Double issue containing 78-page forecast of prospects for various investments, ranging from stocks to art, in 1986. Notable quote: Analysts expect the bull market to last for years. | Business Week<br>12/30/85 |
| "Recent Developments in the Bankers Acceptance Market" | Traces the rapid expansion of the dollar-denominated bankers acceptance market through the 1970s and early 1980s and the subsequent contraction of this market beginning in early 1983. Article concludes that market may very well continue to contract, given the proliferation of attractive substitutes as a result of financial innovation and deregulation. | Federal Reserve Bulletin<br>January 1986 |

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A8825-1

# Securities Industry Trends

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AN ANALYSIS OF EMERGING TRENDS IN THE SECURITIES INDUSTRY
Produced by the SIA Research Department

February 5, 1986

## Special Trends Issue

This issue of Securities Industry Trends will introduce a new SIA service, SIA's International Newsletter. A special section of this initial newsletter includes an abridged version of a document produced by SIA's Research Department and International Committee on barriers faced by U.S. securities firms in overseas capital markets. This document was requested by the OECD and has been distributed to the 24 OECD countries for their reactions as well as within the U.S. Government.

## Why a Newsletter?

SIA's Research Department and International Committee believe that the continuing integration of the U.S. domestic capital market with foreign capital markets and increases in portfolio investment in both directions clearly calls for increasing awareness among member firms. In fact, a recent three-part series in the New York Times on foreigners' role in the U.S. noted that "foreign investments are approaching $1 trillion and have created an estimated 2.5 million American jobs." Foreign securities firms are playing an increasing role in the U.S. capital markets. For instance, several Japanese securities firms have applied to become primary dealers in U.S. government securities. Of course, U.S. securities firms have not been left behind as they have become major players in overseas capital markets and several recently became members of the Tokyo Stock Exchange.

We hope this newsletter serves to stimulate interest about international markets and provides data and written material about internationalization that readers may have missed. If it does, than it will serve its purpose.

Any comments you may have on the newsletter or document should be sent to SIA's Research Department. If you wish to continue receiving copies, please send in the attached orange form.

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## DEVELOPMENTS IN INTERNATIONAL SECURITIES MARKETS

Recent events, such as the G-5 decision on floating exchange rates, underscore the growing interdependence of the world's economies. Within this framework, the world's financial markets are becoming increasingly interdependent. In many cases, securities firms react to events occurring outside of their country of domocile almost as if the event occurred inside their country.

This newsletter is a response to the trend commonly called internationalization and will periodically cover issues and events overseas which now, or later, have an impact on U.S. broker-dealers doing business in foreign markets as well as impacting foreign entities doing business in the U.S.

## JAPAN PERMITS FOREIGNERS SEATS ON EXCHANGE

The Tokyo Stock Exchange (TSE), under continuing pressure from foreign countries and intermediaries to liberalize their financial markets, recently admitted six foreign firms to membership on the TSE beginning in 1986. This removed one obstacle for foreign firms doing a securities business in Japan. Four Japanese firms were also admitted, raising the total number of seats on the TSE to 93.

The cost of a seat on the Exchange will be about $5 million (about 10 times the cost of a seat on the NYSE). U.S. firms admitted to the TSE were Goldman, Sachs, Merrill Lynch and Morgan Stanley. Three firms from the UK were also admitted: Jardine Fleming Securities, Vickers da Costa and S.G. Warburg.

A seat on the TSE offers significant advantages. For instance, foreign securities firms without a seat were required to pay a 27% commission to a Japanese broker for his role as an intermediary in executing orders on the TSE. A seat will allow the firm to avoid this commission and keep the total fee which, over the course of a year, could be substantial (a recent article in the Financial Times noted that "Jardine Fleming paid $13.2 million in commissions to Japanese brokers in the year to September").

### US ORGANIZATIONS WITH BRANCHES IN JAPAN[1]

| Name | Number of Employees | Starting Date of Operations in Japan |
|---|---|---|
| Merrill Lynch | 196 | July 1972 |
| Vickers da Costa (Citicorp) | 39 | October 1978 |
| Bache | 35 | January 1980 |
| Smith Barney | 35 | January 1980 |
| Salomon Brothers (Asia) | 21 | August 1982 |
| Kidder Peabody | 28 | June 1983 |
| Goldman Sachs | 20 | November 1983 |
| Morgan Stanley | 80 | June 1984 |
| First Boston | 43 | June 1985 |

## GLOBAL FOREIGN EXCHANGE MARKET DOUBLES DURING LAST FIVE YEARS

A recent survey completed by the Group of Thirty, a research organization of international experts, concluded that the size of average daily turnover in the global foreign exchange market has doubled to $150 billion over the last five years. London continues as the world's largest foreign exchange market, with average daily foreign exchange trading volume rising from about $25 billion in 1979 to $49 billion in 1984.

New York is the second largest market, rising an estimated $18 billion, to $35 billion per day. Zurich, the fourth largest market in 1979, rose to third largest, with average daily turnover at $20 billion.

### FOREIGN EXCHANGE CENTERS

$bn

| | 1979 | 1984 |
|---|---|---|
| London | 25 | 49 |
| New York | 17 | 35 |
| Zurich | 10 | 20 |
| Frankfurt | 11 | 17 |
| Tokyo | 2 | 8 |
| Singapore | 3 | 8 |
| Hong Kong | 4 | 8 |
| Paris | 4 | 5 |
| Total | 75 | 150 |

Median estimates of average daily turnover
Source: Group of 30

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[1] IDD, July 1, 1985, p.8

London and New York have not increased their percentage of the market share during the past five years, holding at 56% in both 1979 and 1984. However, during this same period, Far Eastern countries increased their share from 11% to 16%.[2]

## NASD AND LSE READY TO SWAP STOCK QUOTES

The National Association of Securities Dealers (NASD) and the London Stock Exchange (LSE) recently took a first step toward 24-hour trading. The two organizations have agreed to swap stock quotes during a two year pilot program.

The purpose of this agreement is to expand the hours during which investors on the two markets can receive stock quotes. For instance, U.S. investors will have the ability to learn the price British market makers will sell or buy a stock for prior to the opening of the NYSE.

NASDAQ will display price quotes on stocks listed in the Financial Times-Stock Exchange 100 and 180 non-British stocks in which there is active market making in London off the floor. The LSE will receive quotes on 200 leading NASDAQ companies as well as 75 non-British companies whose ADRs are traded on NASDAQ.

## ANNUAL SYMPOSIUM ON INTERNATIONAL OPERATIONS DISCUSS LINKAGES

The National Securities Clearing Corporation recently announced that through the establishment of a subsidiary called the International Securities Clearing Corporation (ISCC), a clearing linkage with the London Stock Exchange will be developed. This announcement was made at the Annual Symposium of the International Operations Association.

Addressing the Symposium, Gerard P. Lynch, Chairman of the Board, NSCC, noted that the purpose of the linkage would be to provide U.S. investors with access to the UK's clearing system (TALISMAN) and permit UK investors to clear through the U.S's ISCC/NSCC/DTC mechanism. Trades settled in each country will continue on their usual settlement cycle, the U.S. trade date plus five and the UK fortnightly system.

The long term objective of the NSCC is to establish links with other worldwide clearing and depository organizations.

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[2] The survey can be obtained by contacting the Group of Thirty, 725 Park Avenue, New York, N.Y. 10021, Attn: The Foreign Exchange Markets in the 1980's. Pre-payment ($15) is required.

Mr. Lynch noted some of the benefits occurring as a result of these linkages are:

1) local custodians, experienced with local country laws and practices, are utilized;

2) dealers have a single access point for all processing; and

3) trades are compared early in the cycle.

## U.S. CORPORATIONS FIND EUROBOND MARKET ATTRACTIVE

U.S. corporations, in search of additional capital at lower financing costs, are increasingly turning toward the flourishing Eurobond market. The Eurobond market, which in 1976 raised just under $14.5 billion, increased five-fold to a record $79.5 billion in 1984. During the first nine months of 1985, total capital raised in the Eurobond market shattered the 1984 record and stood at $98 billion.[3] The full year 1985 figure stood at $134.4 billion.

Frequently, U.S. corporations have found financial prospects in the Eurobond market cheaper than in the domestic market. This fact is supported when Eurobond financing by U.S. corporation is looked at as a percentage of corporate debt offerings. Since 1980, there has been a 412% increase in U.S. corporations utilizing Eurobond financing.

### Corporate Debt Issues by American Corporations in the U.S. and Overseas Markets

($ Billions)

| | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|
| Capital raised overseas[4] | $ 4.1 | $ 6.2 | $12.6 | $ 6.0 | $21.0 |
| Capital raised in the U.S. by debt | 41.6 | 46.4 | 57.2 | 52.2 | 69.3 |
| TOTAL RAISED | $45.7 | $52.6 | $69.8 | $58.2 | $90.3 |
| Money raised overseas as a % of total | 9.0% | 11.8% | 18.1% | 10.3% | 23.3% |

Sources: Morgan Guaranty Trust and Securities Industry Trends

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[3] Morgan Guaranty Trust's World Financial Markets.

[4] Eurobond issues only, excludes foreign bonds

## STUDY OF EUROBOND MARKET SUGGESTS INCREASING CONCENTRATION

Carol L. Courtadon, in a recent study produced by NYU's Salomon Brothers Center for the Study of Financial Institutions, indicates that while competition among Eurobond underwriters is fierce, concentration in the market is increasing. Additionally, issues require larger capital commitments with increasing distribution capability. If this trend continues, market share will become increasingly concentrated by a relatively few underwriters.

**Market Concentration: Lead Manager Shares of New Eurobond Issues, 1979-1984**

| | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|
| Aggregate Lead Manager Shares of New Eurobond Issues: | | | | | | |
| Top 3 lead managers | 24% | 23% | 24% | 32% | 33% | 32% |
| Top 5 lead managers | 32 | 31 | 35 | 41 | 41 | 44 |
| Top 10 lead managers | 50 | 47 | 51 | 57 | 54 | 61 |
| Top 15 lead managers | 61 | 58 | 63 | 66 | 65 | 70 |
| Top 25 lead managers | 76 | 72 | 75 | 78 | 78 | 83 |

Source: "The Competitive Structure Of The Eurobond Underwriting Industry", Carol L. Courtadon, Salomon Brothers Center for the Study of Financial Institutions.[5]

## ON-LINE INFORMATION FOR THE EUROMARKETS

DAFSA KOMPASS, a Paris based producer of on-line information, serves both the financial and corporate markets on an international scope. Portfolio analysts and managers can receive stockmarket and bond data via PC. Information on the corporate market includes financial reports on lending European companies. The database also includes news worthy events related to securities.

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[5] The study also covers the distribution techniques of Eurobonds as well as an analysis of Floating Rate Note, Straight Bond, and Convertible and Warrant Issue Sectors. Copies of the study can be obtained by contacting Salomon Brothers Center for the Study of Financial Institutions, 90 Trinity Place, New York, N.Y. 10006.

In January of 1984, DAFSA KOMPASS came to an agreement with AP, Dow Jones and Quotron. Under the terms of this agreement, DAFSA data bases were made available throughout Europe, the United States and the rest of the world via the Quotron network. Further information on DAFSA can be obtained by writing Jean-Daniel De Jonge, Director-DAFSA, Avenue Louise, 4, 176, Box 4 B-1050 Brussels (Belgium)

Short Notes:

- Regulatory authorities in the U.S. and U.K. recently met to discuss barriers between the two countries which impede investors. They also discussed the exchange of market surveillance information.
- The NYSE has recently formed a committee to advise its board on the European corporate community's views on international securities and business matters.
- Looking for information on the swap market. Call the International Swap Dealers Association, Inc., 122 East 42nd Street - Suite 1700, New York, N.Y. 10168, 212/972-3088.
- The Dutch Government recently unveiled new measures to deregulate their market. The Amsterdam Stock Exchange will also cut its commission rates, for the second time this year. The Exchange is also making overtures toward U.S. brokerage firms to become members.
- Despite threat of suit by the Chicago Mercantile Exchange, the Philadelphia Stock Exchange is expected to introduce ECU contracts and link the trading of these contracts to the European Options Exchange.
- Japan's Ministry of Finance (MOF) has granted a securities license to Drexel Burnham Lambert.
- The Big Bang, scheduled for this October, will mean an end to fixed commissions on the LSE. Robert Fleming, an English merchant bank, notes that a large proportion of trades will be carried out on a net basis, hence the bank forecasts a sharp drop in commission rates.

# EXTRACTS FROM
# BARRIERS TO INTERNATIONAL SECURITIES MARKETS ENCOUNTERED BY U.S. BROKER-DEALERS

RESEARCH DEPARTMENT,
SECURITIES INDUSTRY ASSOCIATION
October, 1985

## France

Foreign exchange controls in France are the single largest impediment to foreign firms doing business in France. In order for French residents to buy foreign securities, they must use a French broker as an intermediary. This raises costs to the U.S. broker-dealer who must pay a fee to the French broker for his service as an intermediary.

Another serious competitive impediment to U.S. broker-dealers in France are the regulations requiring French citizens to leave their securities with a qualified intermediary approved by the authorities. French banks and French brokers, qualify for such a classification, but foreign broker-dealers do not. French citizens channeling business through U.S. broker-dealers are obligated to deposit their securities with a French bank or French broker.

France has very stringent laws with respect to colportage and demarchage. Colportage is forbidden altogether, and demarchage is permitted only by banking institutions and by agents de change and their solicitors, all of whom are subject to specific government regulation. The French penal provisions run from one to ten years imprisonment and up to 180,000 francs in fines, and civil actions may be brought for damages or recision. These laws severely limit the ability of the representative offices of foreign securities firms to develop business. Strictly speaking, all business solicitation should be limited to the banks and agents de change themselves. The only business United States broker/dealers can pursue are those prospects who come to the representative offices on their own initiative, and prospects who have independently requested information about opening an account.

Finally, membership on the Paris Bourse is confined to French citizens only.

## Germany

The securities business in Germany is considered to be a banking activity covered under the German Banking Act. Once a banking license is obtained, there are few impediments to doing a securities business. Indeed, this is one of the easiest countries to do business in for U.S. broker/dealers.

However, requirements for obtaining a banking license can be onerous for most foreign firms. "According to German Banking Law, the purchase and sale of securities on behalf of third persons constitutes a banking transaction (Section 1 of the "Gesetz uber das Kreditwesen"). Anyone wishing to engage in banking transactions in the Federal Republic of Germany must obtain permission from the Federal Credit Control Board ("Bundesaufsichtsamt fur das Kreditwesen").

Such permission does not mean that a broker-dealer must engage in a full range of banking activities. Presumably, a foreign brokerage firm obtaining a banking license can choose to limit its activities to brokerage. Once the foreign firm has received permission from the Federal Credit Control Board, it can be admitted to the German Stock Exchanges under the same conditions as a German credit institution.

Thus, a U.S. broker-dealer can operate in Germany if it is willing to meet all the required conditions of a banking institution. In many instances, certain foreign entities wishing to conduct only a brokerage and not a full fledged banking business may find the requirements imposed for obtaining a banking license too stringent.[1]

Unwritten regulations - gentlemen's agreements - provide that no member invited into an underwriting deal by the German banks as a co-manager will compete with the lead manager for the same issuer's next investment banking transaction.[2] In fact, according to a leading financial publication, a co-manager has never been allowed to be a lead manager.[3]

There is also a problem with commodities and options trading, which U.S. firms consider part of the everyday securities business in the U.S. These activities are considered as equivalent to "gambling" by the authorities. In certain situations, this may preclude a foreign firm from recovering monies owed by a customer as a result of such transactions.

## Japan

While Japan's securities markets show signs of opening up to foreign firms, considerable barriers still exist.

In order to engage in a full-fledged brokerage business in Japan, it it necessary to obtain authorization from the Ministry of Finance to set up a branch.[4] This process takes considerable time. As far as we can gather, only two individuals process applications for authorization for foreign securities firms to set up a branch. The individuals also have the additional burden of processing applications for Japanese firms which wish to establish branches overseas. Hence, both U.S. and Japanese firms are affected. In addition, authorization for setting up a branch will only be given if a minimum of 20 individuals work for the office. While this is an "unwritten law", branch status is almost impossible to obtain without this minimum number of people. In addition, the branch manager must be a resident of Japan.

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[1] NYSE's "Recommendations on Access and Membership by Foreign-Controlled Broker-Dealers to the U.S. Securities Markets", June, 1974.

[2] Euromoney, February 1985, p.73.

[3] Ibid, p.73.

[4] As at December 12, 1985, the total number of foreign owned securities dealers in Tokyo was 20.

Even if a foreign broker-dealer obtains a license from the Ministry of Finance to engage in the brokerage business, the Japanese stock exchanges make membership difficult to obtain.

Without the ability to be a member of the exchange, business in Japan is severely impeded. Foreign firms which have a securities business license to operate as a branch must pay a 23% commission to the Japanese broker for his role as an intermediary to the retail client. Foreign firms without a license to do securities business in Japan, but which have representative office status, must pay a 80% commission. Similarly, a broker-dealer in the United States having neither branch or representative status must also pay a 80% commission to the Japanese broker. There is no difference between selling stocks which are listed, or non-listed, on a Japanese stock exchange; the commission structure noted above holds.

Finally, a commodities business may only be done if the firm does not trade securities. This regulation stands for both Japanese and foreign firms. Unfortunately, this type of regulation is devastating to U.S. broker/dealers where the securities and commodities business are handled under the same roof.

We also note recent pronouncements by the Ministry of Finance which indicate that banks, securities houses and insurance companies should restrain the purchases of foreign securities. This is detrimental to firms which seek such business and might lessen the desirability of a Japanese investor interested in buying foreign stocks, bonds, etc.[5]

Sweden

The principal barrier to primary or secondary market activities in U.S. securities in Sweden is that all overseas

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[5] Indeed, curbs on the outflow of capital are already in place. An article in the September 21, 1985 issue of The Economist noted that "...insurance firms, trust banks and

(Footnote continued on next page)

securities purchases by Swedish residents, corporate or individual, must be done through an initial purchase of a foreign currency from a pool of finite size. In addition, a premium must be paid to acquire this currency; currently, the level is about 25%.

Subject always to the investment currency, Swedish investors are only permitted to buy listed foreign securities. This precludes their buying non-listed stocks, including mutual funds, which have been popular in the U.S. during recent years. While not a discriminatory practice, options and futures trading is, strictly speaking, prohibited, although in practice a reasonable degree of "flexibility" seems to have been displayed by the authorities in the application of these regulations, i.e. some activity does take place in these derivative instruments. In addition, options on the stock of Sweden's six largest companies have recently been listed on the Swedish Stock Exchange, so (de facto) some liberalization in this area may be developing.

Apart from the clear-cut barrier to investment banking activities in the context of U.S. corporations raising money in Sweden, described above, there is another major impediment relating to the issuance by Swedish corporations of securities in overseas markets, including the United States. Swedish corporations have two classes of shares, restricted and free. One or two large companies are "grandfathered" and most of their shares are free e.g. Ericsson, Electrolux. On average however, only about 20% of a company's stock is free. The significance of this is that only free stock may be bought by foreign investors and thus, when such foreign investors wish to purchase Swedish securities, a premium - at times significant - must be paid. Approximately 6%-7% of the Swedish stock market is believed to be owned by foreign investors.

Swedish corporations have been encouraged to raise capital abroad in the fixed income markets. Although a permit to do so is required, they have been readily granted and a large number of issues have been done. It is not a requirement of the authorities, but traditionally, one of the two major Swedish banks' London investment banking arms has always been involved in these issues as a co-manager.

A permit is required by foreign investment banks to open a branch in Sweden. The Central Bank has made it known that the issuance of such permits is likely to be limited although, given the present environment, there is little point in applying for such a permit, since all of the potential

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pension funds are not allowed to invest more than 10% of their assets abroad."

investment banking and securities business appears to be covered more than adequately from either a London or other European (or even a U.S.) base.

## Switzerland

While the Swiss capital market is one of the most important capital markets in the world, Swiss monetary authorities have restricted access to it for foreign broker/dealers. Recently, the deregulation of competing international markets has moved the Swiss government to open its market.

There are several serious impediments for a foreign firm when setting up a branch in Switzerland. Work permits, which are necessary for brokerage activities, are extremely hard to obtain in Switzerland. In addition, foreign branch offices are required to hire Swiss residents. Also, capital requirements for foreign branches can be quite onerous for a smaller firm wishing to do a limited business in Switzerland. Finally a "surety bond" must be placed with the government.

Underwriting privileges in Switzerland are also restricted. The largest banks lead manage 70 to 75% of all Swiss Franc bond issues for foreign borrowers.[6] If foreign firms try to penetrate this market, the Swiss banks threaten foreigners with loss of business that they were receiving in the past. However, the large number of foreign banks, in particular investment banks, in Switzerland (about 200 as of December 1985) have raised the eyebrows of Swiss banks. Current talk among Swiss banks is to subject foreign investment banks which lead-manage issues to the same capital requirements as banks. They must also designate competent management and, what is a major condition, reciprocity.

One of the most severe impediments in Switzerland is the "gentlemen's agreement". Simply stated, the "agreement" prohibits foreign firms from calling on local or non-residents to do a retail business or advertising to increase business. Non-observance of this "agreement" could elicit a response from the Swiss banks which would effectively ban a "violating" firm from the underwriting market. Additionally, non-observance by U.S dealers could lead them to be blacklisted by Swiss banks, eliminating their receiving the traditional brokerage business channeled for execution on the U.S. exchanges.

In addition, secondary market activity (for Swiss and non-Swiss broker dealers) is impeded by the stamp duty and brokerage fees payable on every transaction, although there is no duty on same-day trading, only on positions held overnight.[7]

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6/ Euromoney, August 1985, p.43.

7/ Ibid, p.59.

Membership is difficult, if not impossible, for foreign firms on the Zurich Stock Exchange.

## United Kingdom

Many U.S. firms currently have offices in the United Kingdom in which they do a substantial Eurobond business. Recent developments in England indicate a willingness to further liberalize their markets for foreign securities firms. Underscoring the trend toward liberalization are decisions to abolish fixed commission rates and the dual capacity system, allowing firms to perform both brokerage and dealing activities.

Unfortunately, certain barriers still remain. For instance, ownership of Stock Exchange firms by foreign firms is limited to 29.9%. Yet, full ownership of Stock Exchange firms by foreigners may be allowed after March 31, 1986. Anticipation of such a ruling has already prompted investments by U.S. brokers and banks in member firms of the London Stock Exchange.

The Bank of England does not permit foreign-owned institutions to lead in the distribution of new issues within the domestic sterling capital market unless "in the Bank's view there are reciprocal opportunities in their domestic capital markets for equivalent UK-owned institutions."

## EUROMARKET TURNOVER
($000,000)
(1/2/86 - 1/23/86)

Primary Market

| | Eurobond Straights | Eurobond Convertibles | Floating Rate Notes | Other Bonds & Instruments |
|---|---|---|---|---|
| US DOLLAR ISSUES | $9,146.8 | $142.7 | $2,013.8 | $714.7 |
| OTHER CURRENCIES | $2,820.0 | $2.7 | $1,974.2 | $251.4 |

Secondary Market

| | Eurobond Straights | Eurobond Convertibles | Floating Rate Notes | Other Bonds & Instruments |
|---|---|---|---|---|
| US DOLLAR ISSUES | $59,277.4 | $3,171.8 | $40,752.9 | $7,066.2 |
| OTHER CURRENCIES | $17,728.0 | $465.1 | $8,042.0 | $8,031.9 |

| | CEDEL | EUROCLEAR | TOTAL |
|---|---|---|---|
| US DOLLAR ISSUES | $37,456.9 | $84,829.5 | $122,286.4 |
| OTHER CURRENCIES | $19,612.0 | $19,703.4 | $39,315.4 |
| TOTAL | $57,068.9 | $104,532.9 | $161,601.8 |

## MARKET VALUE OF EQUITY SHARES OF DOMESTIC COMPANIES*

| EXCHANGE | DECEMBER 31, 1980 (US $ Millions) | DECEMBER 31, 1981 (US $ Millions) | % CHANGE 1980-1991 | DECEMBER 31, 1982 (US $ Millions) | % CHANGE 1981-1982 | DECEMBER 31, 1983 (US $ Millions) | % CHANGE 1982-1983 | DECEMBER 31, 1984 (US $ Millions) | % CHANGE 1983-1984 |
|---|---|---|---|---|---|---|---|---|---|
| AMERICAN | $46,863.8 | $40,199.7 | -14.2% | $45,043.2 | 12.0% | $57,574.4 | 27.8% | $52,001.1 | -9.7% |
| ASSOC. AUSTRAILIAN | 59,668.5 | 24,379.7 | -59.1% | 41,525.8 | 70.3% | 54,036.1 | 30.1% | 49,939.6 | -7.6% |
| AMSTERDAM | 29,370.3 | 23,873.2 | -18.7% | 25,712.7 | 7.7% | 33,741.6 | 31.2% | 35,425.6 | 5.0% |
| BASEL | 36,732.4 | 32,532.3 | -11.4% | 33,245.9 | 2.2% | 38,980.5 | 17.2% | 36,883.0 | -5.4% |
| BARCELONA | 15,373.0 | 15,340.5 | -0.2% | 10,413.7 | -32.1% | 9,062.5 | -13.0% | 11,588.8 | 27.9% |
| BRUSSELS | 10,033.1 | 8,369.2 | -16.6% | 8,565.2 | 2.3% | 10,779.0 | 25.8% | 12,342.0 | 14.5% |
| BUENOS AIRES | 3,954.9 | 1,396.2 | -64.7% | 972.9 | -30.3% | 1,386.3 | 42.5% | 1,170.7 | -15.6% |
| COPENHAGEN | 5,543.1 | 6,172.6 | 11.4% | 5,545.3 | -10.2% | 10,211.7 | 84.2% | 7,588.1 | -25.7% |
| ASSOC. OF GERMAN | 71,715.7 | 62,583.4 | -12.7% | 68,953.1 | 10.2% | 82,869.5 | 20.2% | 78,368.2 | -5.4% |
| GENEVA | 37,581.2 | 35,245.9 | -6.2% | 36,822.3 | 4.5% | 42,529.7 | 15.5% | 38,733.6 | -8.9% |
| HELSINKI | N/A | N/A | N/A | 2,759.4 | N/A | 4,133.7 | 49.8% | 4,167.1 | 0.8% |
| HONG KONG | 39,013.3 | 38,890.9 | -0.3% | N/A | N/A | N/A | N/A | N/A | N/A |
| JOHANNESBURG | 100,000.7 | 74,856.3 | -25.1% | 77,848.0 | 4.0% | 82,756.2 | 6.3% | 53,388.3 | -35.5% |
| KOREA | 3,828.8 | 4,224.3 | 10.3% | 4,407.7 | 4.3% | 4,386.8 | -0.5% | 6,222.4 | 41.8% |
| KUALA LUMPUR | 12,393.6 | 15,298.6 | 23.4% | 13,877.6 | -9.3% | 22,699.1 | 63.6% | 19,333.6 | -14.8% |
| LONDON (1) | 205,182.7 | 189,563.1 | -7.6% | 196,251.2 | 3.5% | 225,837.0 | 15.1% | 236,403.4 | 4.7% |
| LUXEMBOURG (2) | 3,994.1 | 4,457.3 | 11.6% | 4,685.8 | 5.1% | 5,798.9 | 23.6% | 6,647.7 | 14.6% |
| MADRID | 16,564.8 | 16,677.9 | 0.7% | 11,168.1 | -33.0% | 10,918.7 | -2.2% | 13,232.1 | 21.2% |
| MEXICO (3) | 12,993.9 | 10,100.2 | -22.3% | 1,718.8 | -83.0% | 3,007.2 | 75.0% | 3,661.4 | 21.8% |
| MILAN | 25,340.2 | 23,957.3 | -5.5% | 19,926.4 | -16.8% | 20,908.9 | 4.9% | 25,721.3 | 23.0% |
| MONTREAL | N/A | N/A | N/A | 103,546.4 | N/A | 117,004.2 | 13.0% | 112,078.1 | -4.2% |
| NEW YORK | 1,190,534.0 | 1,098,561.0 | -7.7% | 1,258,722.0 | 14.6% | 1,522,160.0 | 20.9% | 1,529,458.6 | 0.5% |
| OSAKA | 331,153.3 | 371,972.7 | 12.3% | 370,568.3 | -0.4% | 467,638.7 | 26.2% | 545,339.1 | 16.6% |
| OSLO | 3,190.1 | 3,334.4 | 4.5% | 2,395.6 | -28.2% | 4,602.9 | 92.1% | 5,793.9 | 25.9% |
| PARIS | 54,616.1 | 38,127.5 | -30.2% | 29,645.9 | -22.2% | 38,139.7 | 28.7% | 41,058.2 | 7.7% |
| RIO DE JANEIRO | N/A | N/A | N/A | N/A | N/A | N/A | N/A | N/A | N/A |
| SAO PAULO | N/A | 12,577.1 | N/A | 10,260.5 | -18.4% | 15,099.7 | 47.2% | 29,140.6 | 93.0% |
| SINGAPORE | 24,412.0 | 34,807.6 | 42.6% | 11,732.6 | -66.3% | 15,525.3 | 32.3% | 12,246.5 | -21.1% |
| STOCKHOLM | 12,909.8 | 17,215.8 | 33.4% | 18,596.8 | 8.0% | 30,167.7 | 62.2% | 25,674.1 | -14.9% |
| TEL AVIV (4) | 4,808.4 | 6,970.1 | 45.0% | 15,917.3 | 128.4% | 5,084.9 | -68.1% | 6,120.1 | 20.4% |
| TOKYO | 379,211.7 | 417,943.1 | 10.2% | 417,405.2 | -0.1% | 545,849.3 | 30.8% | 644,413.3 | 18.1% |
| TORONTO | 118,346.2 | 105,573.8 | -10.8% | 103,546.4 | -1.9% | 140,630.0 | 35.8% | 134,554.3 | -4.3% |
| VIENNA (5) | 1,956.0 | 1,583.6 | -19.0% | 1,509.7 | -4.7% | 1,528.2 | 1.2% | 1,485.7 | -2.8% |
| ZURICH | 42,730.9 | 38,347.2 | -10.3% | 38,745.6 | 1.0% | 44,081.2 | 13.8% | 40,077.4 | -9.1% |
| TOTAL | $2,900,016.6 | $2,775,132.5 | -4.3% | $2,992,035.4 | 7.8% | $3,669,128.6 | 22.6% | $3,820,257.9 | 4.1% |

1) LONDON: Excludes Ireland.
2) LUXEMBOURG: Data inlcude investment funds in amounts of $5,029.0 mil. in 1984, $4,287.2 mil. in 1983, $3,083.7 in 1982, $2,940.5 mil. in 1981 and $2,540.6 mil. in 1980.
3) MEXICO: Data pertain to 178 domestic issuers in 1984, 160 in 1983, 161 in 1982, 151 in 1981 and 108 in 1980.
4) TEL AVIV: Includes convertibles.
5) VIENNA: Includes investment funds.

*Translated to U.S. $ at year-end exchange rates.

SOURCE: **FIBV Activities and Statistics**

## RECENT INTERESTING READING AND STATISTICAL MATERIAL

| Item | Description | Source |
|---|---|---|
| International Trade in Services: Banking | This report, produced by the Organization for Economic Cooperation and Development, details restrictive practices in OECD member countries which present banking services. Topics covered include, Cross-Border International Banking Operations, Reciprocity Provisions and Regulations Restricting and Foreign Acquisitions of Participations in Indigenous Banks. | Director of Information<br>OECD<br>2, rue Andre-Pascal<br>75775 Paris, CEDEX 16,<br>France |
| Corporate Taxes: A World Wide Summary | This guide summarizes basic information about corporate taxes in 94 countries and territories. It briefly outlines corporate tax rates and reviews major features of tax laws that affect corporate operations. | Price Waterhouse Center For Transnational Taxation<br>1251 Avenue of the Americas<br>New York, NY 10020 |
| World's Major Stock Exchanges: Listing Requirements | A guide for those companies considering possible listing on a foreign exchange. General background is provided and is not intended to be a compendium of all requirements. | Price Waterhouse Center For Transnational Taxation<br>1251 Avenue of the Americas<br>New York, NY 10020 |
| Securities Market In Japan: 1984 | A book explaining the Japanese capital markets systems. A historical view of the Japanese securities market is also given. Information on stocks, bonds and securities taxation is also given. | Japanese Securities Research Institute<br>c/o Tokyo Shoken Kaikag<br>1-5-8, Nibonbashi - Kayabasho<br>Chuo-Ku, Tokyo 103 Japan |
| Tokyo Stock Exchange Fact Book 1985 | Designed to clarify recent trends in the Japanese securities markets with statistical data provided by the TSE and other related organizations. Data includes brokerage commission rates, criteria for stock listing and share volume. | Tokyo Stock Exchange<br>Research Department<br>1-1, Nihombashi-Kayaba-Cho<br>2-Chome |

| | | |
|---|---|---|
| Comparison of Individual Taxation of Long and Short Term Capital Gains on Portfolio Stock Investments in Seventeen Countries | A report providing an overview of the taxation of gains realized on the sale of portfolio stock investments by individual residents of eleven major industrialized countries and six Pacific Basin countries. Also included is a description of any wealth or net worth taxes which would apply to securities. | Research Department<br>Securities Industry Association<br>120 Broadway<br>New York, NY 10271<br>$15 per copy |
| Foreign Activity in U.S. Securities | A quarterly report that tracks purchases and sales of U.S. securities by foreign investors. Third quarter data showed foreign net purchases of U.S. equities jumping to $1.4 billion from $529 million in the second quarter. | Research Department<br>Securities Industry Association<br>New York, NY 10271<br>Members $30.00/year<br>Others $48.00/year |

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Produced by the SIA Research Department

A8825-1

Vol. XII, No. 3 March 7, 1986

# DISTRIBUTION AND CHANGING CUSTOMER NEEDS

## A Summary of Presentations at the 1986 Trends Conference[1]

The theme of the 1986 Trends Conference was "Distribution and Changing Customer Needs." Deregulation, a change in customer behavior and new technologies have brought new competitors into the financial services business. These forces have changed the fundamental economics underlying the securities industry. This, in turn, has led to questions concerning current distribution techniques and experimenting with new ones.

This issue of Securities Industry Trends summarizes the conference speakers' remarks concerning distribution in the financial services industry.

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[1] The full transcript of the 1986 Trends Conference is available for $75. An order form is enclosed.

Securities Industry Association

# STRATEGIC DISTRIBUTION

## "The Role of Distribution in Meeting Customer Needs -- and Making a Profit -- in Today's Financial Services Environment"

William T. Gregor
Anne Benedict
Management Analysis Center, Inc.

Distribution channels -- the mechanisms that deliver products to customers -- have undergone tremendous change in recent years, fueled by both deregulation and new technologies. Rule 415 has reduced the number of syndicate participants; and negotiated rates have led to increased institutional influence on pricing and service decisions and to substantially increased principal trading. Deregulated commissions have seen the rise of discount brokers as a significant force in the retail market. While these changes are occurring, new technologies are altering marketing, operations, and distribution costs. At the same time, customer needs are also evolving, with increasing demands for new kinds of service, product features, and distribution alternatives.

To respond to these forces, firms have developed a range of offerings that combine products of varying complexity with a number of different distribution channels designed to meet various customer needs. For example, commodity products like money market mutual funds do not require a great deal of added value through distribution; and consumers will buy them through the mail. Options trading, on the other hand, is a complex, customized offering for which customers demand -- and are willing to pay for -- personal service and expertise; in other words, high value-added.

### Distribution in a Changing Environment

Distribution is more than just sales; it also plays an important role in customer maintenance, through transaction delivery, customer service and revenue collection. The new environment has changed both the kinds of distribution channels offered and the cost structure of the business and made distribution an element that must be managed. Distribution is costly, about 80 percent of total costs or revenues for a full service broker. In each of the three major sectors of the securities industry -- that is, in the underwriting and sale of primary issues, in secondary trading, and in retail distribution -- firms are finding new ways to remain competitive and profitable.

### Distribution of Primary Issues

The initial stage of securities distribution is the underwriting and sale of primary offerings, and this business is dominated by so-called investment banks. Because of several factors, these firms have seen few new entrants relative to other areas of the securities industry. Still, this market is changing, because Rule 415 has fostered increased competition and because customers are demanding more services.

The big players in this business have the capital, the customer base, the talent, and the prestige to compete for a wide range of customers and offer virtually any product; the trick is to determine which markets and products are truly profitable. For smaller entrants, a "niche-player" strategy is necessary: they must focus on the areas they can serve well and target distribution channels to deliver the products their customers want, within the limitation of their resources. Like the full-service firms, they must match their distribution benefits to the complexity of their products.

## Distribution in Secondary Trading

In the ten years since commission rates were deregulated, the structure and nature of competition has changed significantly in the secondary trading sector. The institutionalization of the market has meant greater sophistication among investors and new competitive demands. Investment bankers and full-service firms that dominate the primary offering market are also players in the secondary market distribution channels, as are some niche players. Another set of competitors -- third party brokers -- have joined the secondary market in the last decade as well, and have developed pricing strategies that have driven down commissions throughout the industry.

Increased customer sophistication has led to a change in the approach to distribution. Commissions have come under scrutiny by institutional investors, who are demanding that rates reflect the value added by the broker/dealer rather than a flat per-share rate for all types of trades. Customers have also expressed dissatisfaction with research and other services. At the same time, customers are willing to invest in a broader range of instruments. These new demands on firms have turned the brokers of the 1970s into today's dealers.

Players in the secondary market, along with those in the retail market, have made some radical changes in their distribution channels, the most dramatic of these being the increased use of automation to improve distribution capabilities and reduce costs. New products, including financial futures, restricted stock sales, mortgage-backed securities, and high yield bonds, are yet another distribution innovation.

## Distribution at the Retail Level

Competition -- from banks, insurance companies, and retailers, along with the forces of increasing customer sophistication and more new products -- has radically altered this segment of the securities market. Even though institutional trading now dominates the market, individual investors' investments in mutual funds, equities, pension funds, government securities, and credit market instruments has increased dramatically: from $1.9 trillion in 1968 to $6.6 trillion in 1984.

As in other markets, customer needs have changed, too. Individual investors are more willing to try new products and experiment. They need a wide range of products, demand service, and vote with their feet. Responding to those demands has meant changes in the distribution channels in the retail sector -- the most complex distribution network in all the securities markets.

Where once the account executive and full-service firm was the norm, now they are only one of a number of channels: direct mail, telemarketing, electronic delivery are all vying for the same customer base. Each channel offers different value-added and has a different cost structure, giving rise to the most important challenges facing securities firms today. The cost of the traditional account executive is fast becoming prohibitive: the dollars spent on compensation and on housing the sales force represent nearly 60 percent of revenues. Changing that system is also expensive and account executives who feel threatened often leave, taking their clients with them.

## ISSUER, INSTITUTIONAL AND INTERNATIONAL DISTRIBUTION

### "Distribution and Changing Issuer Needs"

Terrence Connelly
Vice President of Corporate Finance
Salomon Brothers Inc

The effects of deregulation and related trends on issuer activity is the core of what is happening in our business. The impact of deregulation on the structure and management of investment banks can be viewed in a general sense first. No one in our business is unfamiliar with the entry of the Japanese universal banks and the competition we face from, for example, Nomura Securities. Niche strategies have also developed as participants in our industry have defined areas such as high yield securities, focused on technology and the financing of financial institutions and the like.

Intensified price competition almost goes without saying in a deregulated environment, and it is very much a part of life since deregulation in the securities industry. The unbundling and rebundling of financial products and services is very much part of what I will outline today. I encourage you to think about how our industry has taken the products that we are used to selling and found new ways to separate their constituent elements or bring them together.

This phenomena of unbundling and rebundling is at the core of specific types of issuer related developments. To some degree, our industry resembles an airline with the type of price competition that has come to the deregulated airline industry especially in the last two years. We are familiar with airline unbundling -- think of People Express and the unbundling of the cost of baggage handling as well as unbundling of meals and drinks.

You might think that this is stretching things a bit but if you look at the airline advertisements in the financial and other pages of our morning newspaper, we can recognize how our own industry is beginning to market this way. Perhaps a quick look at our own advertising, 20% off, how to save money on financing, begins to suggest that the patterns between our industry and the airlines are not that dissimilar. As we stretch this point further, the frequent flyer program resembles our industry coming to the point where we are talking about frequent funding programs.

I want to talk about five themes in detail. They are Innovation, Globalization, Securitization, Deequitization (the retirement of equity) and Concentration, which is resulting from the most important action of deregulation in the investment banking business -- Rule 415.

First, the innovation theme really links very closely with what we are discussing about bundling and unbundling. Think back to 1979 and consider the action of the Federal Reserve in October of that year, deregulating to a certain extent the price or the cost of money, interest rate controls, the management of interest rates and the fundamental changes affecting both investors and issuers. Problems for investors were created in terms of investment risks with the volatility introduced into the market. Problems for issuers also resulted, from high coupon debt on the balance sheet. The response of our industry was a classic unbundling of principal and interest by way of the zero coupon issues which led in turn in the government market to CATs, TIGRs and the beginning of what can be summarized as the Acronym War.

Since the 1980's began, a series of new products have developed, all of which can be considered examples of unbundling along the lines of zero coupon instruments, or rebundling, such as the matching of a swap with euro financing. A whole series of new products was introduced this past year. In the domestic market, we have witnessed the collateralization or the securitization phenomena -- the pass through of assets such as automobile receivables, commercial real estate, etc. to another group of investors. In the tax-exempt market, the entry of zero coupon capital appreciation bonds, put option securities, adjustable rate securities, are all examples of innovation spurred on by deregulation outside of our industry and in the international markets.

Globalization, indeed, is another major theme which I will touch on only lightly. With the removal of the U.S. withholding tax, the export of innovation accelerated as other major countries in the financial world -- Japan, West Germany, Switzerland, and the United Kingdom -- liberalize their financial markets. This year has seen the first zeros, the duel currency bonds and euro yen bonds introduced in the international capital markets. We have clearly exported deregulation and innovation, and we expect this to continue.

In the past year, U.S. corporations raised $39 billion off shore, twice the volume of 1984 and half the U.S. market volume, with new issue activity in international finance reaching over $165 billion. Accelerating this trend is the relationship between the international market and the growth in particular of the swap market, which is estimated to have grown in excess of $180 billion through the first ten months of 1985. Accurate data for 1985 will suggest the size of that market to exceed over $200 billion.

Securitization is the third major development in the marketplace so far as issuer activity is concerned. Twenty-one percent of the mortgages outstanding and 45 percent of the new residential mortgages are securitized today. Commercial real estate securitization originated in 1984; grew in 1985. The underlying market continues to grow dramatically with $73 billion of new advances in the 1983-1985 period, thus expanding the potential for securitization of the commercial product-line. Last year also witnessed a resurgence of securitization of real estate equity financing, with $4 billion of new issues.

While the real estate equity marketplace shows signs of renewed strength, we also have deequitization. In 1984 and 1985, issuers raised virtually as much for financing mergers & acquisitions, leveraged buyouts (LBO's) and stock repurchases as for new physical or financial assets. The M&A, LBO, and stock repurchase activity -- which is, in part, a response to the threat of unfriendly takeovers -- can be traced to acts of deregulation at the State and Federal levels. In turn, issuers have retired $220 billion of equity in the last two years, virtually 10% of all corporate stock outstanding.

The last major theme for consideration is perhaps the most important for our industry -- concentration. This phenomenon is best addressed not only through our focus on lead managers' market shares, but also by understanding what's happening underneath the statistics. Before Rule 415, between 75-80% of new issues of debt was lead-managed by the top six firms. To see a move to 80-90% in that marketplace after Rule 415 is really not that dramatic; yet there is drama beneath those statistics. First, we need to look at what is happening with respect to the syndicate process. The fundamental fact is that 45 cents of every dollar of new money raised in the U.S. public taxable market since Rule 415 has been raised without a syndicate. These funds were raised by one or two or a few managers buying the whole issue. The number in this particular case jumped up to about 20% shortly after Rule 415 and has been growing roughly at the rate of one-half percent a month, and has now reached 45 cents on the dollar.

Our organizational structure is keyed to our compensation structure and most of our existing profit center allocation systems are clearly obsolete. They pre-date the effects of deregulation in our industry and the integration and product matrices that we are marketing to issuers. Who gets the credit in terms of these obsolete allocation systems for financing, say, for a U.S. company in the Midwest, linked to a cross currency interest rate swap? More importantly, when do they get that credit, because when is that revenue received?

These are the kinds of questions that we have to think anew in terms of the internal structures of our organizations. We have to find ways to integrate our sales, trading, finance and research organizations in ways that mirror the bundling and unbundling of our product mix. Our bonus structures and incentive structures are trapped in a general sense in past concepts that no longer reflect the way profits are made in the industry. The firms that have been successful in a deregulated environment have been successful in spite of, not because of, their internal accounting structures. No one has a good answer to these questions. Without such answers, however, we won't be able to progress into the era that continues to threaten as well as reward us.

## "Distribution and Changing Institutional Investor Needs"

Richard S. Falk
Capital Markets, PaineWebber Incorporated

Prior to Mayday (May 1, 1975), the institutional equity business was relationship oriented with research and other information flows attracting institutional customers. Since Mayday, the institutional securities business has shifted more towards a transactional mode and securities firms found it necessary to develop trading expertise supported by large sums of capital. The traditional bond trading houses also moved into the institutional equity business. As institutional commission rates plunged, trading became an important part of investment strategy. Volume grew rapidly (five times in ten years) and the business became more concentrated. This increased volume helped to offset the effects of a sharp decline in rates.

During the past 10 years, there has been tremendous pressure on the financial services industry and its clients due to economic conditions. The inflation in the late 1970s and early 1980s reduced the real rates of return on investment. At the same time, the cost of servicing financial clients grew dramatically.

Disinflation, while improving the environment for investing, has brought with it a different set of problems. One result has been increased volatility of financial instruments, particularly when viewed globally as nations and companies have struggled to adapt to rapidly changing and adverse economic conditions. This, in turn, has created inefficiencies in valuation of various instruments and sectors. Arbitrage in different instruments has allowed many to capitalize on these inefficiencies. This trend has meant even more trading and transactions crossing international boundaries.

Technology has been a major factor in our industry. In 1969, many regional customers did not have same-day delivery of the Wall Street Journal. Today, large amounts of information can be processed and distributed almost instantly and provided to a larger group at lower cost. Today's money managers are getting more data than ever, and on a split-second basis. This allows them to make more decisions more quickly. This, in turn, leads to greater transactions and greater volatility.

These trends have put pressure on trading and liquidity and created a hunger for new products and strategies. Many of these revolve around trading -- options, futures, and related strategies and arbitrages. Many firms have more computers, programmers, and systems in the trading department than in the research department.

Foreign securities are not a new product, but investing in them is a new strategy for U.S. money managers. Several firms are building up their international research capabilities to rival their domestic efforts.

All of these trends have tended to further institutionalize the marketplace. Individuals have responded by moving increasing amounts of their investment to packaged products lately, especially mutual funds. The distribution of these products has become an important service provided by the brokerage community.

One recent new trend is the creation of converters. They offer access to a variety of investment management and measurement products, and sometimes offer cash rebates to plan sponsors in order to help reduce costs. This has caused a conflict between the growing appetite for liquidity in the form of traditional block trading, OTC market-making, etc. and the siphoning off of the means to compensate for these capital intensive services. One result of this may be increased dealerization of the marketplace over the next five years.

In summarizing the needs of today's institutional clients, they are: (1) liquidity; (2) new products and strategies; (3) instant communication of research and investment strategy information; and (4) access to global markets and product distribution.

## "Distribution and Globalization"

E. Daniel Morris
Morgan Stanley & Co. Incorporated

A global market is defined as a market without national boundaries where prices are based upon supply and demand from around the world and not predominantly from a single market. In today's markets, major currencies and precious metals meet these criteria. The Eurodollar markets come close to this definition, but are in a somewhat different category because of the linkage with the U.S. capital markets. There are, of course, many other national markets where there is worldwide investment participation but where prices are generally determined by domestic considerations. U.S. government securities and equities are examples, and should be referred to as global investment markets.

Despite continuing segmentation of capital markets, the investment of capital is becoming increasingly global. In recent years, American institutions have begun expanding their overseas investment. This is the beginning of what will become a substantial shift in the composition of U.S. institutional investment. A similar trend is underway in Japan where domestic institutions, long confined to the domestic market, have begun to invest sizeable amounts overseas.

The point of this distinction between markets and investments is that, as securities firms, we deal in national markets. However, our clients, the larger issuing entities and investing institutions, clearly are moving toward global strategies.

Deregulation is now proceeding very quickly in London and Tokyo, the two largest overseas market centers. The U.K. government and the City are responding by breaking down the domestic boundaries which have existed between securities dealing, broking and merchant banking. The Gilts market, which accounts for about 75% of volume on the London Stock Exchange, is also being opened to foreign dealers. London is also putting into place an entirely new system of self regulatory organizations (SROs), each dealing with specific sectors of the market. The SROs will operate under a legislated Securities and Investments Board.

Another driving force toward globalization is the privatization taking place overseas. The experience of the Tory government in the U.K. in privatizing publicly held companies is making available a new and relatively large supply of high quality securities for domestic investors, as well as for foreign investors. This trend toward privatization is also occurring under the present socialist government in France. We are seeing similar moves in Italy, Singapore and elsewhere.

Another force driving globalization of investment is technology. There have been major advances in telecommunications systems, management information systems, the availability of real-time trading and settlement systems which have made the markets more efficient. This has also allowed the development of a number of sophisticated new financing tools. These include interest rate swaps, currency swaps, and interest rate futures together with various hedging and arbitrage systems. These have helped link capital markets for issuers as well as investors.

The globalization of investment is also being driven by increasing competition in the management and control of financial assets. In portfolio management, for example, performance is more often being measured in global terms, which takes into account the relative valuation of equities in different markets as well as currency fluctuations. Managers therefore must compare domestic companies with foreign companies.

In Japan, institutional forces for deregulation appear to be even stronger. In the Japanese equity market, domestic institutions are the dominant holders of equity securities. The institutional structure of Japan's financial markets is now undergoing substantial change. Japan's new role as the world's largest capital exporter is one factor bringing about this change.

Examples of new markets in Japan include sales of dollar CDs and CP, mortgage securities, cross currency asset and liability swap products, and yen bond futures. These kinds of market activities were not possible in Japan a few years ago.

There will be continued growth in arbitrage between credits and between markets. Arbitrage and hedging techniques will continue to proliferate. This will facilitate the origination and distribution of issues globally. Last year, over three quarters of the issues in the Euromarkets were linked to swaps and hedging instruments.

Better technology will develop, bringing forth better information flows within and between markets. We are still in the very early stages of adapting computer systems and telecommunications to the markets. As an industry, we will have to continue to make relatively large expenditures on technology over the next several years.

A relatively small number of institutions will be successful on a truly global scale, because many participants will be unable to meet the needs of an ever more sophisticated, inter-related and institutionalized marketplace. However, there will be many successful firms who will not try to be everything to everybody and will specialize in their areas of greatest strength.

## "Distribution Strategies: The Key To Serving A Changing Marketplace"

C. B. Rogers, Jr.
IBM Corporation

The information processing and securities industry have many parallels. Both are extremely competitive. Both serve an expanding customer base and both are handling a dramatic surge in volume. Both industries are keenly affected by the rising cost of people-intensive services. We are both driven by technological innovation. We increasingly exploit the benefits of communications, automation and information processing as an integral part of our business: to control costs, increase productivity and achieve profitability. Thus, operationally, we're both trying to reduce costs, manage complexity and optimize field performance. Strategically, we are both developing new products, services and distribution channels to give us a competitive advantage.

Over the past years, technology has extended the power of information systems to the fingertips of millions of users at a lower cost than ever. We are beginning a phase where the new uses of information are changing the fundamental way in which people live and work. That begins to have broad implications for distribution strategies. To illustrate that point, let's consider a few trends.

Artificial Intelligence seeks to emulate the leaps of logic performed by the human brain. We are already beginning to see software that borrows expert system techniques to recreate human reasoning and make it useable in workstations and personal computers.

Software itself will become easier and more powerful to use as developments in reduced instruction set technology and natural language processing begin to show real promise.

Before I suggest what these changes may mean to your distribution strategies, let me touch briefly on some of the lessons we have learned as we have approached changes in technology and the marketplace.

First, it is possible, although challenging, to add additional channels of distribution, retain existing customers and acquire new ones -- all at the same time. Second, despite overlaps in our coverage strategies, multiple channels of distribution increase overall business. Third, customers like having choice of channels commensurate with the level of support required. Fourth, as technology allows us to enhance and supplement our distribution channels with other methods, we have to ensure that these new customer interfaces represent us with the same quality and performance we expect from our people. Fifth, there is no perfect model for everyone.

We try, like you, to create value in everything we do: in the way we design, develop, package and deliver our products; and in the way we approach our markets on a day-to-day basis through cost reduction, better technology, choices, improved methods of distribution and higher quality.

In the end, it is an organization's ability to do this year in and year out that sets it apart from its competition, and in the final analysis, that's what distribution strategies are all about.

Information is the basic building block of the modern enterprise. It should not be viewed as simply an expense item because, when used properly, it becomes a major resource for revenue production. Information systems plans must be in concert with strategic goals; the two must be linked together for optimal results.

Frequently, chief executives tell me they are frustrated by the inflexibility of their information systems. When a change is made in their business or a new product is added, they are told it will take months to accommodate their plans. I believe much of this can be avoided if the top person in your information systems department is made a member of your strategy development team.

## RETAIL DISTRIBUTION

### "Meeting the Changing Needs of Retail Customers Through the Distribution Mechanism"

John L. Steffens
Merrill Lynch Consumer Markets

Distribution hinges on one thing -- satisfied customers. The customer is king. The reason we distribute the way we do is because the customer said that's what he or she wants by paying for it. If the product doesn't fulfill a need and provide value to the customer then the distribution doesn't matter. The point is that the customer is driving our strategy, our product development and our distribution. If you don't run your business that way I suggest you look again because the customer revolution is not about to go away.

Merrill looks at the customer in terms of lifestyles and needs. The six basic financial service needs of a customer during his lifestyle look like this:

- saving and cash management
- investment
- tax minimization
- protection
- finance
- housing

I should note that the customer here is upscale (a household with $100,000 in income); the customer that nearly everyone in the financial industry is trying to attract.

Lifestyles of each market segment come into play. We feel it is important to know when your customers' needs are the strongest. For instance, a young married couple starts out thinking about financing, saving and cash management and less about tax minimization and retirement. Realizing this, we meet customers' needs and segment our customers. We carefully identified our target client groups with the intention of developing broader and stronger relationships with our clients.

As we segmented, we defined needs and integrated solutions with specially designed products and services. All along the way we made sure there was quality in everything we offered and the way we offered it. We knew the battle of the future would be fought for quality. And we all know what quality is. As Winston Churchill said, "I am easily satisfied with the very best."

For example, our IRA account has more than fifty products that can be put in it; products from the speculative to the very conservative, like bank insured CD's. Similarly, the TIGR and LYON products answered specific needs of specific segments.

We defined needs and integrated solutions with specially designed products and services. As you can see, segmentation is the first step in our distribution development; in some cases Merrill has even developed sub-segments. The basic groupings are capital markets and consumer markets.

On the consumer markets side, we segment the affluent or established investor, our traditional customer. We also have a sub-segment called the emerging investor. The consumer market utilizes our branch system of 10,000 financial consultants in 500 offices around the country. While some have said this system is too expensive, we feel this system gives us an advantage. Personal contact is of real value when helping an individual with his financial portfolio.

If we do our job and define the markets, needs and products, then we have added value for the customer. And he will pay for it.

## "Distributing Investment Products in an Insurance Company Environment"

Stephen L. Brown
John Hancock Mutual Life Insurance Co.

John Hancock and other insurance companies are becoming more investment oriented and competing directly with securities brokers and other purveyors of investment products. In approaching the distribution of investment products, the insurance industry faces many of the same issues as securities firms. These include holding down the cost of distribution, maximizing the efforts of the existing sales force, developing synergy among diverse product lines, making effective use of technology and experimenting with new methods of distribution.

John Hancock's 10,000-member field force remains its dominant distribution system, and we have no intention of doing anything that might harm this strength. The role of John Hancock's traditional distribution system is changing for several reasons, including the need to control costs. One of our key strategies has been the addition of new financial services, including investment products, to give our agents additional sources of income while spreading costs over more products.

Last year, John Hancock's agents earned an average of about 25 percent of their income from mutual funds and other supplementary products, compared with zero percent less than two decades ago. We have been very successful in marketing fixed-income bond funds and other conservative investment products through our agency force, reflecting the middle-income, middle-America marketplace where we are strongest. About 7,400 of our agents are now NASD registered to sell investment products.

We will continue to provide our agents with new financial products to enhance their competitiveness and broaden our cost base. These include mutual funds, as well as tax shelters and other products manufactured by Tucker Anthony and others.

Recently, we joint-ventured a John Hancock real estate partnership with Merrill Lynch in which we manufactured the product and did much of the selling, supplemented by our agency force. Currently, we are putting together a network of regional brokerage firms for additional distribution of our mutual funds.

Variable life products are another central element in our distribution strategies. These products are a hybrid between ordinary life insurance and a security. The initial amount of insurance is guaranteed for life, but above that minimum the insurance amount and cash value depend on the performance of separate accounts chosen by the customer.

We want Tucker Anthony to be a good investment, and they are on schedule in this regard. Tucker Anthony also represents an important entry into upper-income markets, complementing John Hancock's existing strength in serving middle-income customers.

John Hancock also has a fledgling direct response marketing program. This program has been in effect for about two years, and is focused on the sale of certain insurance products by direct mail. These products have expense loads and size limitations that would make them uneconomic for our agents to sell. So far, the results are promising.

In conclusion, we are adding new products, searching for new customers, and broadening our distribution channels, while continuing to emphasize our agency field force. I believe we are well positioned for the no-holds-barred competition in the future financial services industry.

## SPECIFIC RETAIL DISTRIBUTION STRATEGIES

### "Packaged Products as a Distribution Strategy"

John C. Merritt
Van Kampen Merritt Inc.

First, let's look at the packaged product industry with a few numbers. In 1979, the total amount of Unit Investment Trusts (UITs) sold was $3.1 billion. The mutual fund industry managed to sell $6.8 billion of products in 1979. In 1983 the UIT industry sold $14.8 billion while the mutual fund industry expanded to over $40.3 billion. In 1985, the UIT area grew to $15.3 billion while the mutual fund industry raised $110.5 billion.

Let's take a look at why this product has become popular. The customer benefits because the packaging of a tax-exempt UIT allows the customer to acquire bonds which, in many instances, would be unavailable in a rising market because they would go to institutions. The sponsor is capable of buying at the institutional level, in large enough quantity so that he can assure that the individual UIT holder gets his fair share of the product.

Mutual funds afford the same opportunity: they afford professional management for many products. Today, particular efforts can be seen in the growth of U.S. government funds where the packaged product affords a better rate of return then the individual product would if purchased individually.

What type of distribution avenues do most packagers use? Basically, there are three primary types that are used in distributing our product line: direct selling (generally no-load funds), the utilization of selected broker-dealers and a combination of both.

Van Kampen Merritt made a major decision to be a rather unique distributor in the manufacturing chain. Rather than compete for or distribute directly to the individual, we made a decision to be a partner in developing products and distributing it through the NASD network. We view ourselves as a true product manufacturer. Not only are we developing products in the UIT and mutual fund area but we are also expanding in the insurance product line.

One of the biggest questions upper management has to analytically look at is "should we use an outside vendor to distribute the product or should we develop it internally?" In the case of the UIT, approximately a year and a half ago there were probably four to five sponsors. Today, there are over 17 different types of sponsors. This particular industry is probably reaching a saturation point and some of the sponsors will probably not survive during the next two to three years.

One should make sure he analyzes his own firm's distribution capabilities and where the cross over in economies of scales are. And, I think when you look at the UIT industry, if you are doing a national UIT, your economies of scale probably approach $20 million before you are really economically on the plus side over the life of the product. Upper management must also look at questions regarding the number of products to distribute, marketing and capital concentration.

Upper management is increasingly starting to look at product dissemination at the different branch levels. They are also starting to guide different types of products to different types of geographical regions throughout the U.S. As we turn to these types of questions, which we all face in upper management, we have to look to the future and say "where are we going?" One of these areas will be packaged products. We feel strongly that by the early 1990's, 90-95% of all your products will be sold through a packaged medium of some kind.

## "Discounting as a Distribution Strategy"

Edward J. McLeod
Fidelity Brokerage Services, Inc.

This presentation is fairly specific regarding Fidelity Brokerage's experience with discounting as a marketing tool. Discounting has already had a reasonably significant impact on the marketplace. Even allowing for some weakness in the underlying data, we conclude that the discounters' market share of retail commissions has grown to about 8%-9% and we are looking at reasonably steady growth over the next four-year period.

Discount brokers in 1984 are estimated to have captured 20% of the retail trades executed. More importantly, 40% of all retail new accounts are being opened by discount brokers.

About 15% of commission dollars generated by the often-referred to "upscale client," is being collected by discounters. "Upscale" is usually defined as a household with more than $45,000 annual income. A little more than 20% of the commissions generated by the "young upscale" clients is going to discounters. Discounters have to: (1) offer the right price; (2) develop, use, and enhance the most efficient and effective delivery systems; (3) recognize that price alone is not enough to attract customers -- a value-added service of acceptable quality is required; and (4) control and reduce operating expenses vigorously. We are convinced that our customer base calls for more than one delivery mechanism.

Our experience with local branches does not appear to be any different than most other firms. We are able to attract some customers to our firm that we would not attract without a local presence; and some of our customers specifically prefer a local, or in-person, relationship. As we choose sites for new branches, we need adequate and accurate demographics to ensure a large enough potential market in order to make the branch worthwhile. While trying to be sensitive to customers who prefer a local presence, we have to ensure that those branches are sufficiently profitable, or potentially profitable, to justify the expense of local branching.

Fidelity has attempted to define, by trade volume and commission revenues generated, which levels of client we economically service in a branch environment. Customers are identified into categories of "platinum," "gold," and "silver." The "platinum" customer is highly profitable and receives as much immediate and special attention as possible. The "gold" category client is earmarked for directed sales and marketing efforts through the branch manager because these clients, in terms of the volume of business they do, are upwardly mobile from an unprofitable or marginally profitable level to a satisfactorily profitable level. The other possibility is at the "gold" level; a client who was in the highly profitable "platinum" category but slipped downward in terms of the business generated. We try and implement special sales emphasis from the manager and his staff to encourage a return to the most profitable level.

The last category is the "silver" level. This covers clients who do very little business with us, and given the expense of a branch transaction, cannot be profitable to us. Collectively, however, these customers represent a substantial gross income potential, which should be convertible to net income. We provide this level of client with an "800" telephone number through which he or she can transact business, receive a high level of professional transaction service, and at the same time, enable us to earn a profit through the economies of scale possible in a centralized, high-tech environment.

In our usage of telecommunications, we are usually referring to the use of "800" telephone numbers. We generally have our initial customer contact, generated through our advertising, handled centrally and then forwarded to the appropriate branch as a lead referral. We are completing a system which will give all our customers a centralized "800" number to use for quotes, and we have the capability for subsequent order-taking on the phone, or a direct transfer to the appropriate branch, depending on the circumstances.

If we are to be successful, we must think within a broad framework that encompasses the customer we serve; the product we offer; and the delivery systems we use. We have to be flexible in trying to mix-and-match customers, products, and delivery systems. Finally, we must maintain a highly creative approach to the way we function within the marketplace.

## THE ROLE OF TECHNOLOGY IN DISTRIBUTION

### "Technology, Markets, and Distribution"

William M. Saubert, Coopers & Lybrand

The securities industry's attitude toward technology is very revealing. Brokers may be strong on high-tech stocks from time to time, but when it comes to bringing modern communications technology into their own shops, "short interest" runs high. When you compare securities individuals with their counterparts in other financial services, the securities industry is always less optimistic about, less committed to, and less interested in exploiting the benefits of technology.

Brokers say they use technology to keep up with the Joneses. They expect to gain a bit of more strategic help from technology. This is a lot less than that projected by bankers, insurance companies, etc. Technology has fairly well saturated the operational functions across the financial services industry. Almost everyone uses it for distribution and sales. There is a strong drop-off when it comes to using technology to gain competitive advantage. Only one in four brokers uses return on investment or return on asset guidelines to judge technology investments being made either to increase the company's efficiency or to lower the cost of operations. Almost all bankers do. When asked how important technology is to them, brokers rated lower than banks, insurance companies, etc.

Brokers want technology to keep up with the Joneses. They do not evaluate how dollars are spent. They do not find that much use for technology for day-to-day improvements, strategic direction, or a new generation of enhancements. Brokers are by far the most bullish on people. Hardly any see machines taking over for traders and RRs.

It won't do to simply evaluate the technology function as a cost center and compare it to a peer's cost center. That doesn't change your strategic thinking about information processing, which is what you have to do.

Expert systems can quickly sort through high volumes of transactions in many financial instruments and present the best trading situations to the broker. After all, the greatest complicator in the securities environment is the mass and velocity of data that markets generate.

Our survey found that one in five of the executives interviewed had experienced unauthorized access to their computers or databases in the past five years. That's a scary figure. Thus, you should take any steps necessary to protect the integrity of your systems.

Summaries Prepared By:

Jeffrey M. Schaefer
Senior Vice President and
Director of Research

David G. Strongin
Research Associate

VOLUME

| | JANUARY 1986 | YEAR-TO-DATE 1986 | JANUARY 1985 | YEAR-TO-DATE 1985 | % CHAN. Y-T-D. 1986-1985 |
|---|---|---|---|---|---|
| AVERAGE DAILY SHARE VOLUME ON | | | | | |
| NYSE (MILS.)* | 133.4 | 133.4 | 121.5 | 121.5 | 9.8% |
| AMEX (MILS.) | 11.1 | 11.1 | 9.1 | 9.1 | 22.0% |
| NASDAQ (MILS.)* | 107.6 | 107.6 | 84.1 | 84.1 | 30.3% |
| REGIONAL EXCHANGE (MILS.)* | N/A | N/A | 19.3 | 19.3 | N/A |
| DOLLAR VALUE OF SHARES TRADED ON | | | | | |
| NYSE (MILS.) | $105,010 | $105,010 | $89,235 | $89,235 | 17.7% |
| AMEX (MILS.) | 3,058 | 3,058 | 1,930 | 1,930 | 58.4% |
| ODD-LOT SHARES PURCHASED ON NYSE (THOUS.) | 8,269 | 8,269 | 7,484 | 7,484 | 10.5% |
| ODD-LOT SHARES SOLD (INCLUDING SHORT SALES) ON NYSE (THOUS.) | 18,589 | 18,589 | 17,670 | 17,670 | 5.2% |
| NYSE BLOCK VOLUME AS A PERCENT OF TOTAL SHARES TRADED | 49.5% | 49.5% | 51.3% | 51.3% | ---- |
| CONTRACTS TRADED (THOUS.) | | | | | |
| CBOE OPTIONS | 15,226 | 15,226 | 13,948 | 13,948 | 9.2% |
| AMEX OPTIONS | 5,573 | 5,573 | 3,351 | 3,351 | 66.3% |
| COMMODITY | 16,279 | 16,279 | 13,253 | 13,253 | 22.8% |

*MONTHLY AVERAGE
N/A - DATA NOT AVAILABLE

## YIELDS

(MONTHLY AVERAGES)

| | JANUARY 1986 | JANUARY 1985 | BASIS POINT CHG 1986-1985 |
|---|---|---|---|
| BOND BUYER INDEX (20 BOND) | 8.08% | 9.51% | (143) |
| CORPORATE BOND YIELDS (MOODY'S) | | | |
| Aaa CORPORATE | 10.05 | 12.08 | (203) |
| Baa CORPORATE | 11.44 | 13.26 | (182) |
| RATIO Aaa CORPS. TO Baa CORPS. | 0.88 | 0.91 | (3) |
| MUNICIPAL BOND YIELDS (MOODY'S) | 8.08 | 9.51 | (143) |

## PRICES

(END OF MONTH)

| | FEBRUARY 1986 | FEBRUARY 1985 | % CHAN. Y-T-D 1986-1985 |
|---|---|---|---|
| DOW JONES INDUSTRIALS | 1709.06 | 1284.01 | 33.10% |
| STANDARD & POOR'S 500 | 226.92 | 181.18 | 25.25% |
| NYSE COMPOSITE | 130.74 | 104.93 | 24.60% |
| AMEX MARKET VALUE INDEX | 257.35 | 227.43 | 13.16% |
| VALUE LINE COMPOSITE | 229.56 | 197.66 | 16.14% |
| NASDAQ COMPOSITE | 359.53 | 284.17 | 26.52% |

## UNDERWRITING

| | FIRST QUARTER 1986 | FIRST QUARTER 1985 | % Change 1986-1985 |
|---|---|---|---|
| CORPORATE FINANCING (Gross New Issues - Millions) | | | |
| TOTAL | 12,735 | 5,952 | 114.0% |
| Common Stock | 1,915 | 636 | 201.1% |
| # of Common Stock Issues | 43 | 32 | 34.4% |
| Preferred Stock | 645 | 265 | 143.4% |
| # of Preferred Stock Issues | 9 | 5 | 80.0% |
| Corporate Debt | 10,175 | 5,051 | 101.4% |
| # of Corporate Debt Issues | 115 | 65 | 76.9% |

| | FEBRUARY 1986 | FEBRUARY 1985 | % Change 1986-1985 |
|---|---|---|---|
| MUNICIPAL FINANCING | | | |
| TOTAL (Bonds Only) | 4,535 | 12,837 | -64.7% |
| Notes | N/A | N/A | N/A |
| Bonds | N/A | N/A | N/A |

## MARGIN DEBT

| | JANUARY 1986 | JANUARY 1985 | % CHANGE 1986-1985 |
|---|---|---|---|
| MARGIN DEBT OUTSTANDING ($MILS) | 26,810 | 22,090 | 21.4% |
| NET CHANGE IN MARGIN DEBT ($MILS) | 4,720 | (780) | -705.1% |
| % OF ACCOUNTS WITH EQUITY UNDER 40% | 10% | 10% | ----- |

## FINANCIAL DATA FOR NYSE FIRMS DOING A PUBLIC BUSINESS
## (MILLIONS OF DOLLARS)

| | Third Quarter 1985 | Yr. -To-Date 1985 | Third Quarter 1984 | Yr. -To-Date 1984 | % Change 3rd Q. 1985 3rd Q. 1984 | Yr. -To-Date % Change 1985 - 1984 |
|---|---|---|---|---|---|---|
| REVENUE | | | | | | |
| SECURITIES COMMISSION INCOME | $1,865 | $6,012 | $1,766 | $5,387 | 5.6% | 11.6% |
| TRADING PROFITS | 2,100 | 6,913 | 2,005 | 5,134 | 4.7 | 34.7 |
| UNDERWRITING | 1,013 | 2,720 | 659 | 1,836 | 53.7 | 48.1 |
| TOTAL REVENUE | 8,815 | 27,024 | 8,324 | 22,698 | 5.9 | 19.1 |
| TOTAL EXPENSES | 8,144 | 24,392 | 7,632 | 21,594 | 6.7 | 13.0 |
| NET INCOME BEFORE TAXES | 671 | 2,632 | 692 | 1,104 | (3.0) | 138.4 |
| PERCENT OF FIRMS SHOWING LOSS | 32.4% | NA | 30.9% | NA | --- | --- |

## RECENT INTERESTING READING AND STATISTICAL MATERIAL

| Item | Description | Source |
|---|---|---|
| Economic Report of the President | Annual report prepared by the Council of Economic Advisers examining the state of the economy and future outlook. This year's report details inflation and disinflation in the macroeconomy and also focuses on the developing countries and world trade. Comprehensive statistical tables relating to income, employment and production. | Superintendent of Documents<br>U.S. Government Printing Office<br>Washington, DC 20402 |
| Corporate Finance 1985: The Red Hot Year | Domestic financing volume soared to a record $138.3 billion in 1985, compared with $82.4 billion in 1984. IDD's annual issue details corporate finance for year, with ranking of book manager and co-manager by type of issue. Also includes listings of 25 largest debt and equity deals. | Investment Dealers' Digest<br>1/13/86 |
| "Financial services--who owns the future?" | While brokers are an expensive way to sell products, the amount of new capital brought in by direct marketing techniques is but a fraction of the capital brought in by brokers in direct contact with customers. Article concludes that big brokers will continue to own the largest piece of the financial services market, but not necessarily the most profitable. | Forbes<br>2/24/86 |
| "Mutual Funds: Assets Soar, Performance Doesn't" | In 1985, investors poured $114.3 billion into stock, bond and income funds, dwarfing 1984's record inflow of $45.9 billion. However, while some funds outperformed the averages, most did not. Special section reviews performance of various types of funds based on Lipper gauge, with emphasis on fourth-quarter. | Barron's<br>2/17/86 |
| Innovation in the International Capital Markets | Four-part, specially sponsored supplement reviewing deregulation in certain foreign markets and the avenues that have been opened for international capital raisers. In addition, the practical mechanics of some of the new instruments in international financing are covered, including swaps. | Euromoney Supplement<br>January 1986 |

| | | |
|---|---|---|
| The Liquidity of Alternative Money Centers: A Comparison of the NYSE, Amex, and NASDAQ National Market System | Two NYU professors measure liquidity in the three markets via a "market efficiency coefficient", which relates short-period to longer-period volatility. Concludes: Design of the market has a substantial impact on liquidity. As currently structured, exchange markets are more liquid than the NASDAQ/NMS system. | American Stock Exchange |
| "Glory Days for IRAs" | Special report detailing the many choices available to individuals opening, adding to, and shifting IRA accounts. | Money<br>March 1986 |
| "The Business Transfer Tax-- A VAT By Any Other Name" | Article describes BTT and tax reform proposals introduced by Senator Roth, which would impose a tax on the value added at each level of production through a subtraction-method VAT. The mechanics, impact, trade aspects and prospects of the BTT are reviewed. Of note: the BTT would fall significantly and disproportionately on service companies and other businesses that otherwise would benefit from the proposed rate reduction of tax reform. | Tax Notes<br>2/24/86 |
| Taxpayer Behavior and the Distribution of the 1982 Tax Cut | Using 1982 data, paper examines the effect of the 1981 Tax Act on the responsiveness of taxpayers to tax rates and incentives, foregone revenue, and the distribution of the tax burden. Concludes: there was a significant behavioral response to the rate reductions of 1982. On average, about half of the revenue which would have been lost due to rate reductions was recouped. The data also suggest that an actual increase in revenue occurred for top bracket taxpayers, making it likely that the revenue maximizing top marginal rate is below the 70% which existed prior to 1982. | Working Paper No. 1760<br>National Bureau of Economic Research<br>1050 Massachusetts Avenue<br>Cambridge, MA 02138 |

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Vol. XII, No.4 April 9, 1986

## 1985's SECURITIES INDUSTRY PROFITABILITY REBOUND

### Highlights

1. In 1985, the securities industry earned a record net income, both on a pre- and after-tax basis. The $4.1 billion pre-tax profit achieved last year was up 158% over 1984. Any applauds, though well deserved, over that rise must be tempered with the memory of how poor a year 1984 was to begin with. Compared to better times back in 1983, last year's pre-tax record profits were only ahead 7.9%.

2. Since profits were at record levels, naturally revenues were also. Last year's $38.6 billion showing in this area was up 23.7% over 1984 and 30.4% over 1983. The big story is that this revenue rise far outpaced rises in expenses which translates into a fatter bottom line.

3. The best showing in profitability and revenue gains were all during the fourth quarter. With the bull market in full swing during those months the pace of gains was torrid...at levels experienced during the industry's best years. In fact, the $1.5 billion pre-tax profit in 1985's final quarter was second only to the $1.6 billion earned in 1982's final three months. This hopefully will carry over into record showings in 1986's first quarter.

4. One factor which drove the bull market which in turn fueled the profit gains also had counterbalancing effects. For instance, falling interest rates (last summer for the first time since 1978, the prime rate returned to single digit levels) kept revenues from margin interest from doing better than it could have on 1985's record activity.

5. The industry's balance sheet has been expanding, but more so on the liability side. At last year's close total liabilities hit a record $394 billion while total ownership equity also hit a record $17 billion.

## Table 1

## STATEMENT OF INCOME
## TOTAL SECURITIES INDUSTRY
(In $ millions)

| | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 |
|---|---|---|---|---|---|---|
| REVENUE | | | | | | |
| Commissions | 5682.1 | 5339.6 | 6011.9 | 8350.2 | 7094.6 | 8238.4 |
| Listed Equities, On an Exchange | 4237.5 | 3954.7 | 4484.1 | 6131.5 | 5232.6 | 6069.8 |
| Listed Equities, OTC | 44.6 | 72.8 | 61.0 | 112.4 | 75.0 | 92.3 |
| Options | 714.8 | 608.4 | 737.4 | 797.5 | 822.3 | 881.4 |
| All Other | 685.2 | 703.6 | 728.9 | 1308.6 | 964.7 | 1205.0 |
| Gains/Losses from Trading Accounts | 3137.8 | 4237.5 | 5951.5 | 6839.0 | 7563.8 | 9944.3 |
| Mkt Making-OTC Equities | 664.4 | 607.3 | 655.7 | 1381.3 | 862.9 | 1229.8 |
| OTC Mkt Making-Listed Equities | 60.3 | 38.3 | 37.7 | 51.7 | 45.7 | 52.5 |
| Trading-Debt Securities | 1894.2 | 3081.3 | 4454.6 | 4418.1 | 5524.9 | 7206.5 |
| Mkt Making-Options | 1.9 | -1.0 | 11.1 | 63.6 | 31.1 | 159.1 |
| All Other Trading | 577.3 | 549.7 | 828.4 | 982.7 | 1147.7 | 1348.7 |
| Gains/Losses from Investment Accounts | 560.1 | 573.7 | 606.8 | 738.1 | 713.8 | 1089.2 |
| Realized Gains/Losses | 426.2 | 570.1 | 380.1 | 495.7 | 697.7 | 837.9 |
| Unrealized Gains/Losses | 104.0 | -23.7 | 159.9 | 166.2 | -10.4 | 187.3 |
| Profits/Losses from Underwriting | 1327.8 | 1568.1 | 2316.1 | 3541.4 | 2706.1 | 4250.3 |
| From Equities | 403.3 | 424.1 | 328.2 | 754.5 | 248.3 | 748.4 |
| Margin Interest | 2088.7 | 2890.1 | 2010.5 | 2129.5 | 2867.8 | 2577.7 |
| Revenue from Sale of Investment Company Shares | 104.7 | 122.0 | 287.5 | 952.1 | 750.9 | 1642.8 |
| Fees-Supervision,Advisory,Administrative | 175.4 | 274.8 | 356.1 | 569.5 | 693.8 | 947.4 |
| Revenue from Research Services | 14.3 | 15.8 | 8.3 | 18.7 | 11.1 | 17.6 |
| Commodities Revenue | 625.4 | 580.5 | 663.0 | 826.1 | 739.3 | 983.2 |
| Other Revenue-Securities-Related | 1727.6 | 2965.4 | 3942.3 | 4385.0 | 6282.8 | 7176.4 |
| Other Revenue | 586.1 | 1229.1 | 1055.9 | 1216.8 | 1792.1 | 1757.7 |
| Total Revenue | 16029.7 | 19796.1 | 23210.0 | 29566.4 | 31216.0 | 38621.2 |
| EXPENSES | | | | | | |
| RR Compensation | 3049.8 | 3334.2 | 4103.6 | 5750.2 | 5248.5 | 6903. |
| Clerical & Admin. Employee Expenses | 2548.1 | 3086.3 | 3702.8 | 4889.8 | 5147.5 | 6218.5 |
| Partners & Officers - Employment Expenses | 567.8 | 648.2 | 753.9 | 982.1 | 934.1 | 1119.9 |
| Other Employee Comp. * | 169.7 | 190.5 | 258.0 | 448.2 | 396.1 | 331.3 |
| Floor Expenses | 753.6 | 725.4 | 863.8 | 1142.9 | 1162.6 | 1310.3 |
| Brokerage Paid to Brokers | 263.2 | 265.3 | 316.7 | 390.1 | 399.1 | 441.9 |
| Commissions & Clearance | 283.0 | 246.6 | 275.7 | 390.4 | 395.3 | 459.5 |
| Clearance Paid to Non-brokers | 162.2 | 156.1 | 207.9 | 246.6 | 257.9 | 285.3 |
| Commissions Paid To Others * | 45.2 | 57.4 | 63.5 | 115.8 | 110.3 | 123.6 |
| Communications | 837.5 | 1103.3 | 1270.3 | 1538.4 | 1766.4 | 1921.8 |
| Occupancy & Equipment | 514.1 | 678.4 | 853.3 | 1138.4 | 1503.7 | 1830.7 |
| Promotional Costs | 347.2 | 456.9 | 530.2 | 735.1 | 769.2 | 841.5 |
| Interest Expense | 3444.8 | 5684.7 | 5480.7 | 6057.5 | 9505.4 | 10127.6 |
| Losses-Errors and Bad Debts | 204.5 | 153.6 | 193.3 | 233.0 | 212.0 | 266.3 |
| Data Processing Costs | 156.1 | 216.7 | 273.1 | 342.8 | 419.8 | 477.8 |
| Non-recurring Charges | 30.9 | 16.7 | 6.9 | 98.5 | -26.2 | 98.9 |
| Regulatory Fees and Expenses | 65.9 | 79.2 | 100.9 | 133.9 | 144.9 | 244.8 |
| Other Expenses | 1077.2 | 1280.7 | 1784.3 | 2251.3 | 2372.3 | 2797.4 |
| Total Expenses | 13767.4 | 17651.8 | 20175.4 | 25742.9 | 29608.2 | 34481.2 |
| Net Income | 2262.3 | 2144.3 | 3034.6 | 3823.5 | 1607.8 | 4140.0 |
| Net Income-After Tax | 1221.6 | 1157.9 | 1638.7 | 2064.7 | 868.2 | 2235.6 |

* From FOCUS Short Form, IIA

## INTRODUCTION

## 1985: THE START OF SOMETHING GOOD FOR THE SECURITIES INDUSTRY

Based on last year's bonus checks at securities firms, the Dow, the Bond Buyer Index, etc., everyone knew 1985 was a great deal better than 1984. But now it is official. The full year financials for all NYSE member firms doing a public business are now completed, processed, studied and analyzed. And what they show is HOW it was better, WHY it was better and WHERE it can improve.

In general, after 1984's disastrous showing by the securities industry, the second act had to be better. And it was...much better. Full year 1985's profitability shot back up sharply, but still failed to match levels of better days in the early Eighties. The fourth quarter, however, was the bonanza period where all major revenue and profitability gains mirrored the steep climb in the markets as the bull gained momentum. During this period, profitability measures, such as quarterly ROE, did match the best showings the industry mustered in years 1981 through 1983.

Low inflation and falling interest rates drove this bull market and the bull towed the industry along. Last year's favorable climate for the industry is still warming up today, with inflation and interest rates falling further, the bull market keeps sending market indices to higher record levels.

A walk through the industry's income statement and balance sheet will show what the good news, as well as the bad, is.

## REVENUES - THAT'S MORE LIKE IT

Out of the ashes of a pitiful 1984 for most of the securities industry arose a strong 1985. Last year, securities industry revenues for NYSE firms dealing with the public galloped ahead 23.7% to a record $38.6 billion. This rise was in line with the industry's best years that followed the phenomenal 1980 (when revenues soared 42.9%) comparing favorably to 1981 and 1983 (revenues up 23.8% and 27.6%, respectively.) What was even better - revenue increases far outpaced rising expenses, up 16.6%, to show an impressive 158% increase in securities industry profitability last year.

The $31.1 billion of revenues posted in the previous year, 1984, also showed a year-to-year increase but much less so - only 5.4%. But the real story in 1984 was that expenses increased at a much faster pace than revenues, 15.2% vs 5.4%, so that 1984 industry profitability dove almost 58% from 1983. If we ignore 1984 and look at the two most recent favorable years, 1985 vs 1983, we receive a clearer picture on how the industry is doing in keeping its costs in line with revenue growth, thereby generating greater profits.

## Table 2

## STATEMENT OF INCOME
## TOTAL SECURITIES INDUSTRY
## PERCENT OF TOTAL REVENUES

| | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 |
|---|---|---|---|---|---|---|
| REVENUE | | | | | | |
| Commissions | 35.4 | 27.0 | 25.9 | 28.2 | 22.7 | 21.3 |
| Listed Equities, On an Exchange | 26.4 | 20.0 | 19.3 | 20.7 | 16.8 | 15.7 |
| Listed Equities, OTC | 0.3 | 0.4 | 0.3 | 0.4 | 0.2 | 0.2 |
| Options | 4.5 | 3.1 | 3.2 | 2.7 | 2.6 | 2.3 |
| All Other | 4.3 | 3.6 | 3.1 | 4.4 | 3.1 | 3.1 |
| Gains/Losses from Trading Accounts | 19.6 | 21.4 | 25.6 | 23.1 | 24.2 | 25.7 |
| Mkt Making-OTC Equities | 4.1 | 3.1 | 2.8 | 4.7 | 2.8 | 3.2 |
| OTC Mkt Making-Listed Equities | 0.4 | 0.2 | 0.2 | 0.2 | 0.1 | 0.1 |
| Trading-Debt Securities | 11.8 | 15.6 | 19.2 | 14.9 | 17.7 | 18.7 |
| Mkt Making-Options | 0.0 | 0.0 | 0.0 | 0.2 | 0.1 | 0.4 |
| All Other Trading | 3.6 | 2.8 | 3.6 | 3.3 | 3.7 | 3.5 |
| Gains/Losses from Investment Accounts | 3.5 | 2.9 | 2.6 | 2.5 | 2.3 | 2.8 |
| Realized Gains/Losses | 2.7 | 2.9 | 1.6 | 1.7 | 2.2 | 2.2 |
| Unrealized Gains/Losses | 0.6 | -0.1 | 0.7 | 0.6 | 0.0 | 0.5 |
| Profits/Losses from Underwriting | 8.3 | 7.9 | 10.0 | 12.0 | 8.7 | 11.0 |
| From Equities | 2.5 | 2.1 | 1.4 | 2.6 | 0.8 | 1.9 |
| Margin Interest | 13.0 | 14.6 | 8.7 | 7.2 | 9.2 | 6.7 |
| Revenue from Sale of Investment Company Shares | 0.7 | 0.6 | 1.2 | 3.2 | 2.4 | 4.3 |
| Fees-Supervision,Advisory,Administrative | 1.1 | 1.4 | 1.5 | 1.9 | 2.2 | 2.5 |
| Revenue from Research Services | 0.1 | 0.1 | 0.0 | 0.1 | 0.0 | 0.0 |
| Commodities Revenue | 3.9 | 2.9 | 2.9 | 2.8 | 2.4 | 2.5 |
| Other Revenue-Securities-Related | 10.8 | 15.0 | 17.0 | 14.8 | 20.1 | 18.6 |
| Other Revenue | 3.7 | 6.2 | 4.5 | 4.1 | 5.7 | 4.6 |
| Total Revenue | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |
| EXPENSES | | | | | | |
| RR Compensation | 19.0 | 16.8 | 17.7 | 19.4 | 16.8 | 17.9 |
| Clerical & Admin. Employee Expenses | 15.9 | 15.6 | 16.0 | 16.5 | 16.5 | 16.1 |
| Partners & Officers - Employment Expenses | 3.5 | 3.3 | 3.2 | 3.3 | 3.0 | 2.9 |
| Other Employee Comp. * | 1.1 | 1.0 | 1.1 | 1.5 | 1.3 | 0.9 |
| Floor Expenses | 4.7 | 3.7 | 3.7 | 3.9 | 3.7 | 3.4 |
| Brokerage Paid to Brokers | 1.6 | 1.3 | 1.4 | 1.3 | 1.3 | 1.1 |
| Commissions & Clearance | 1.8 | 1.2 | 1.2 | 1.3 | 1.3 | 1.2 |
| Clearance Paid to Non-brokers | 1.0 | 0.8 | 0.9 | 0.8 | 0.8 | 0.7 |
| Commissions Paid To Others * | 0.3 | 0.3 | 0.3 | 0.4 | 0.4 | 0.3 |
| Communications | 5.2 | 5.6 | 5.5 | 5.2 | 5.7 | 5.0 |
| Occupancy & Equipment | 3.2 | 3.4 | 3.7 | 3.9 | 4.8 | 4.7 |
| Promotional Costs | 2.2 | 2.3 | 2.3 | 2.5 | 2.5 | 2.2 |
| Interest Expense | 21.5 | 28.7 | 23.6 | 20.5 | 30.5 | 26.2 |
| Losses-Errors and Bad Debts | 1.3 | 0.8 | 0.8 | 0.8 | 0.7 | 0.7 |
| Data Processing Costs | 1.0 | 1.1 | 1.2 | 1.2 | 1.3 | 1.2 |
| Non-recurring Charges | 0.2 | 0.1 | 0.0 | 0.3 | 0.1 | 0.3 |
| Regulatory Fees and Expenses | 0.4 | 0.4 | 0.4 | 0.5 | 0.5 | 0.6 |
| Other Expenses | 6.7 | 6.5 | 7.7 | 7.6 | 7.6 | 7.2 |
| Total Expenses | 85.9 | 89.2 | 86.9 | 87.1 | 94.8 | 89.3 |
| Net Income | 14.1 | 10.8 | 13.1 | 12.9 | 5.2 | 10.7 |

* From FOCUS Short Form, IIA

The $38.6 billion in revenues achieved in 1985 were up 30.4% over 1983. The $34.5 billion in expenses incurred last year, though not up much from 1984, were still up 34.2% over 1983. That's a slightly faster increase than revenue growth. Therefore, though profitability increased a dramatic 158% from $1.6 billion in 1984 to $4.1 billion last year, the industry is really doing only 7.9% better than back in 1983 when pre-tax profits were $3.8 billion (excluding extraordinary gains/losses). Thus, self-satisfaction should be more modest than first blush appearances from the euphoria of 1986.

Most of the thanks for the revenue gains goes to the bull market. The fourth quarter was by far the year's best quarter for revenues with $11.6 billion received during that period or 30.1% of 1985's total. A comparatively modest rise in gross margin interest revenue kept fourth quarter revenue gains from being even more impressive. Interest rates fell (the prime rate finally returned to single digit levels last summer, the first time it was below 10% since 1978) counterbalancing a rise in margin debt outstanding to a record $28.4 billion in December.[1]

By category of revenue, it was practically an across the board sweep for the fourth quarter with every major revenue source posting its 1985 quarterly high and only some minor revenue categories being nudged out slightly by prior quarters. Commission revenue, principal activities, underwriting profit, margin interest and other securities business related revenue all had their best showing in the final quarter. Just how these revenue areas did are discussed below.

## COMMISSIONS - LESS BANG PER BUCK

Though the current super bull market's euphoria may have dimmed some memories of the year just gone by, 1985's securities industry record performance should not be bowed to and then forgotten since, upon analysis, it reveals many of the trends still driving the industry towards hopefully another record year of profits.

Commission dollars continue to be one of the major industry revenue sources, though less so than several years ago. In the aggregate, revenues generated through commissions last year bounced back sharply from 1984's level and almost, but not quite, matched the record amount generated in 1983's bull market. The $8.2 billion of commission dollars raised in 1985 were up a hefty 15.5% over 1984, when only $7.1 billion was received. The 1983 record was $8.4 billion, just overshadowing last year's commission revenues.

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[1] NYSE Marketing Research Report, 3/18/86.

## Table 3

## STATEMENT OF INCOME
## TOTAL SECURITIES INDUSTRY
(In $ millions)

| | 1985:1 | 1985:2 | 1985:3 | 1985:4 |
|---|---|---|---|---|
| REVENUE | | | | |
| Commissions | 2155.6 | 1973.7 | 1857.8 | 2251.3 |
| Listed Equities, On an Exchange | 1605.2 | 1474.2 | 1353.7 | 1636.7 |
| Listed Equities, OTC | 20.8 | 22.3 | 23.2 | 26.0 |
| Options | 236.2 | 200.6 | 181.1 | 263.5 |
| All Other | 293.5 | 276.8 | 299.9 | 334.8 |
| Gains/Losses from Trading Accounts | 2342.8 | 2469.1 | 2099.2 | 3033.2 |
| Mkt Making-OTC Equities | 350.3 | 276.3 | 234.9 | 368.3 |
| OTC Mkt Making-Listed Equities | 16.6 | 12.1 | 10.9 | 12.9 |
| Trading-Debt Securities | 1636.2 | 1888.7 | 1529.7 | 2151.9 |
| Mkt Making-Options | 23.7 | 62.7 | 13.8 | 58.9 |
| All Other Trading | 333.1 | 241.4 | 320.8 | 453.4 |
| Gains/Losses from Investment Accounts | 290.6 | 227.2 | 144.6 | 426.8 |
| Realized Gains/Losses | 214.2 | 199.1 | 70.9 | 353.7 |
| Unrealized Gains/Losses | 56.9 | 6.8 | 91.6 | 32.0 |
| Profits/Losses from Underwriting | 698.8 | 1007.4 | 1012.8 | 1531.3 |
| From Equities | 124.3 | 162.7 | 245.3 | 216.1 |
| Margin Interest | 584.8 | 622.7 | 661.6 | 708.6 |
| Revenue from Sale of Investment Company Shares | 323.2 | 451.0 | 482.6 | 386.0 |
| Fees-Supervision,Advisory,Administrative | 191.3 | 217.5 | 244.7 | 293.9 |
| Revenue from Research Services | 2.2 | 4.9 | 7.5 | 3.2 |
| Commodities Revenue | 227.0 | 327.2 | 276.3 | 152.7 |
| Other Revenue-Securities-Related | 1736.4 | 1553.2 | 1606.2 | 2280.6 |
| Other Revenue | 396.7 | 381.3 | 447.3 | 532.4 |
| Total Revenue | 8949.6 | 9234.2 | 8840.5 | 11596.9 |
| EXPENSES | | | | |
| RR Compensation | 1552.7 | 1741.0 | 1699.3 | 1910.6 |
| Clerical & Admin. Employee Expenses | 1392.9 | 1541.6 | 1469.0 | 1815.0 |
| Partners & Officers - Employment Expenses | 288.6 | 271.4 | 262.2 | 297.7 |
| Other Employee Comp. * | 84.0 | 86.4 | 78.8 | 82.1 |
| Floor Expenses | 334.8 | 329.1 | 298.5 | 347.9 |
| Brokerage Paid to Brokers | 114.1 | 104.5 | 103.6 | 119.7 |
| Commissions & Clearance | 121.1 | 108.4 | 111.2 | 118.8 |
| Clearance Paid to Non-brokers | 68.5 | 86.5 | 55.8 | 74.5 |
| Commissions Paid To Others * | 31.1 | 29.7 | 27.9 | 34.9 |
| Communications | 463.4 | 478.9 | 486.7 | 492.8 |
| Occupancy & Equipment | 429.8 | 433.0 | 463.7 | 504.2 |
| Promotional Costs | 186.0 | 197.7 | 198.3 | 259.5 |
| Interest Expense | 2465.4 | 2148.9 | 2312.5 | 3200.8 |
| Losses-Errors and Bad Debts | 44.9 | 69.9 | 66.5 | 85.0 |
| Data Processing Costs | 96.9 | 129.2 | 123.3 | 128.4 |
| Non-recurring Charges | 2.8 | 5.9 | 30.4 | 59.8 |
| Regulatory Fees and Expenses | 50.8 | 53.4 | 63.6 | 77.0 |
| Other Expenses | 622.7 | 723.3 | 591.3 | 860.1 |
| Total Expenses | 8015.9 | 8209.7 | 8133.1 | 10122.5 |
| Net Income | 933.7 | 1024.5 | 707.4 | 1474.4 |
| Net Income-After Tax | 504.2 | 553.2 | 382.0 | 796.2 |

Though last year's near record commissions' showing was a welcome contributor to the Street's bottom line, there were a couple of caveats in this billion dollar bonus. First, securities firms had to sell a lot more product to earn the same commission dollar. Back in 1983 when total commission dollar revenue hit the record $8.4 billion, the bulk, as always ($6.1 billion), came from trades of listed equities executed on an exchange. That represented 0.67%[2] of the total value of those equities traded in 1983 on the exchanges. In the following year, commission revenues from trades on an exchange fell to 0.58% of the underlying value of the shares traded. Last year, as exchange traded equity commissions bounced back to the 1983 level, $6.1 billion, the ratio to the value of shares traded eroded further to only 0.50%. This represents a worrisome 25.4% decrease (0.67% vs 0.50%) in commission dollars relative to the underlying securities in just two years although part of the drop, to be explained shortly, actually has a favorable ramification.

Moreover, the relative contribution of commission dollars to the securities industry's revenues continues to decline. In 1983, commission dollars represented 28.2% of revenues. In 1984, this ratio dropped dramatically to 22.7%, albeit not a very good year to begin with. It was also the first time gains from trading outdistanced commission revenues. Last year, however, as the industry set new revenue and profitability records, commission dollars were playing an even less important part of its growth, contributing only 21.3% to the total revenue pie.

Clearly, the industry finds itself in the position that each year it needs more commission transactions to generate the same commission dollar. This held true in both down (1984) and up (1985) markets.

There appears to be two main explanations for this erosion. First, overall commission rates have been falling for years. This is due to the increased institutionalization of the marketplace and the inherent lower rates with these trades. This has also been one of the contributing factors to the increased competitive atmosphere the Street now works in which in turn has helped drive institutional rates downward.

The second factor has been a shift towards more risk taking in execution. And with the risk, at least in this case, comes greater reward. As securities firms handle more of their equity transactions on a principal basis vs agency, the income

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[2] Commission revenues from equity sales executed on an exchange as reported on FOCUS reports to the NYSE, divided by the dollar value of shares traded on NYSE, AMEX and regional exchanges, as reported by those exchanges.

## Table 4

### STATEMENT OF INCOME
### TOTAL SECURITIES INDUSTRY
### PERCENT OF TOTAL REVENUES

| | 1985:1 | 1985:2 | 1985:3 | 1985:4 |
|---|---|---|---|---|
| REVENUE | | | | |
| Commissions | 24.1 | 21.4 | 21.0 | 19.4 |
| Listed Equities, On an Exchange | 17.9 | 16.0 | 15.3 | 14.1 |
| Listed Equities, OTC | 0.2 | 0.2 | 0.3 | 0.2 |
| Options | 2.6 | 2.2 | 2.0 | 2.3 |
| All Other | 3.3 | 3.0 | 3.4 | 2.9 |
| Gains/Losses from Trading Accounts | 26.2 | 26.7 | 23.7 | 26.2 |
| Mkt Making-OTC Equities | 3.9 | 3.0 | 2.7 | 3.2 |
| OTC Mkt Making-Listed Equities | 0.2 | 0.1 | 0.1 | 0.1 |
| Trading-Debt Securities | 18.3 | 20.5 | 17.3 | 18.6 |
| Mkt Making-Options | 0.3 | 0.7 | 0.2 | 0.5 |
| All Other Trading | 3.7 | 2.6 | 3.6 | 3.9 |
| Gains/Losses from Investment Accounts | 3.2 | 2.5 | 1.6 | 3.7 |
| Realized Gains/Losses | 2.4 | 2.2 | 0.8 | 3.0 |
| Unrealized Gains/Losses | 0.6 | 0.1 | 1.0 | 0.3 |
| Profits/Losses from Underwriting | 7.8 | 10.9 | 11.5 | 13.2 |
| From Equities | 1.4 | 1.8 | 2.8 | 1.9 |
| Margin Interest | 6.5 | 6.7 | 7.5 | 6.1 |
| Revenue from Sale of Investment Company Shares | 3.6 | 4.9 | 5.5 | 3.3 |
| Fees-Supervision,Advisory,Administrative | 2.1 | 2.4 | 2.8 | 2.5 |
| Revenue from Research Services | 0.0 | 0.1 | 0.1 | 0.0 |
| Commodities Revenue | 2.5 | 3.5 | 3.1 | 1.3 |
| Other Revenue-Securities-Related | 19.4 | 16.8 | 18.2 | 19.7 |
| Other Revenue | 4.4 | 4.1 | 5.1 | 4.6 |
| Total Revenue | 100.0 | 100.0 | 100.0 | 100.0 |
| EXPENSES | | | | |
| RR Compensation | 17.3 | 18.9 | 19.2 | 16.5 |
| Clerical & Admin. Employee Expenses | 15.6 | 16.7 | 16.6 | 15.7 |
| Partners & Officers - Employment Expenses | 3.2 | 2.9 | 3.0 | 2.6 |
| Other Employee Comp. * | 0.9 | 0.9 | 0.9 | 0.7 |
| Floor Expenses | 3.7 | 3.6 | 3.4 | 3.0 |
| Brokerage Paid to Brokers | 1.3 | 1.1 | 1.2 | 1.0 |
| Commissions & Clearance | 1.4 | 1.2 | 1.3 | 1.0 |
| Clearance Paid to Non-brokers | 0.8 | 0.9 | 0.6 | 0.6 |
| Commissions Paid To Others * | 0.3 | 0.3 | 0.3 | 0.3 |
| Communications | 5.2 | 5.2 | 5.5 | 4.2 |
| Occupancy & Equipment | 4.8 | 4.7 | 5.2 | 4.3 |
| Promotional Costs | 2.1 | 2.1 | 2.2 | 2.2 |
| Interest Expense | 27.5 | 23.3 | 26.2 | 27.6 |
| Losses-Errors and Bad Debts | 0.5 | 0.8 | 0.8 | 0.7 |
| Data Processing Costs | 1.1 | 1.4 | 1.4 | 1.1 |
| Non-recurring Charges | 0.0 | 0.1 | 0.3 | 0.5 |
| Regulatory Fees and Expenses | 0.6 | 0.6 | 0.7 | 0.7 |
| Other Expenses | 7.0 | 7.8 | 6.7 | 7.4 |
| Total Expenses | 89.6 | 88.9 | 92.0 | 87.3 |
| Net Income | 10.4 | 11.1 | 8.0 | 12.7 |

* From FOCUS Short Form, IIA

from this sector will not be reflected in commission revenues but rather as gains or losses from these trades.

Last year, the net gain from making an OTC market in listed securities rose 14.9% to $52.5 million from $45.7 million in 1984. Though this is a small part of all principal transactions, particularly considering fixed income instruments, it does support the trend. Where the real explosion in principal transactions lies is discussed below.

## TRADING - THE BREAD & BUTTER BUSINESS LINE

Taking a principal position in trading OTC & listed securities has helped this area of revenues prosper but the big picture, all principal trading activities (debt, equities, options) and investment account gains, is where the big money is. Last year, these functions generated $11 billion in net revenues, a new record, up 32.5% from the previous record $8.3 billion set the prior year and triple the level from these activities just five years earlier. This represented 28.5% of all industry revenues last year, by far the industry's new bread and butter business line. Again the trend is towards even better results in the current bull. Of the $11 billion, $3.5 billion, or 31.8% of the year's total, came in the final quarter. That represented an even higher ratio of revenues, 30.2% for the final quarter, compared to the impressive 28.5% for the entire year.

The big ball of wax, as always, came from trading debt. But last year's record $7.2 billion for this area was worthy of an entire wax museum. That figure was up 30.9% from the previous year, 1984's then record $5.5 billion, and up 63.6% over 1983. It was also the most important single product line for the industry last year bringing in 18.7% of all revenues.

The fourth quarter's $2.2 billion (best for the year) showing was not surprising, though perfectly welcome, since the secondary debt market volume over this period headed to record levels. As measured by the market value of corporate debt traded by institutions in the secondary market (excluding member trading), the average daily volume skyrocketed from $8.9 billion in September to a record $12.7 billion in December.[3/] Again, according the SIA's Investor Activity Report, the trend is mighty favorable for debt traders this year. That December record continued to be broken in each of this year's first two months...up to $12.9 billion daily in January and a staggering $15.1 billion daily in February.

Revenue from gains in investment accounts were up 40% last year...setting a new record by breaking through the billion

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[3/] SIA Investor Activity Report, December 1985 issue.

dollar barrier with $1.1 billion posted in 1985. Again the fourth quarter had the best showing, accounting for 39.2% of the year's total.

And while the secondary markets were having a field day, the primary markets were having a picnic of their own.

## UNDERWRITING REVENUE SOARS

Origination, underwriting and selling group revenues last year exploded 59.3% over 1984's $2.7 billion to a new record, $4.3 billion. Though a large amount of that total is increasingly concentrated in a few big hands, the $4.3 billion, 22.9% better than the previous record in 1983, helped a lot of bottom lines from coast to coast.

Investment banking divisions were heartened to see their contribution to the industry's total revenues ricochet back to 11.0% from 8.7% the previous year. Though this didn't match the 12.0% contribution underwriting made in 1983, in perspective it must be remembered that 1985's tasty underwriting slice came from one heck of a large revenue pie. Also, 1983 was the record equity year based on the dollar volume of equity underwritings (where the larger spreads are). Such offerings in 1983 made up one-fifth of the total dollar volume of all primary market deals compared to less than 9% last year.4/

The year-to-year 59.3% underwriting revenue increase was hardly surprising, though no less sweet because of that. On the corporate side, the precipitous interest rate drop in a year's span had profound effects. As measured by many rate indicators such as Fed funds, commercial paper, Euro deposits, or either short or long Treasuries, 1985's average rate fell around 200 basis points from 1984, while continuing an impressive downward movement to-date.5/ Taxable debt issues were flooded onto the domestic markets at a record clip, topping out at $105 billion6/ as corporate treasurers scrambled for cheap funds and to refund mammoth amounts of high cost debt issued earlier.

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4/Investment Dealers' Digest and Public Securities Association.

5/Federal Reserve Bulletin, March 1986.

6/Investment Dealers' Digest.

The rosy rate picture coupled with the economy's best disinflationary environment in decades spilled the enthusiasm over into the equity markets. Everything went up. There were 26% to 31% gains in the DJIA, the NYSE Common Stock Index, S&P's 500 and the NASDAQ Composite indices. Even the AMEX's Market Value Index reversed a three year down pattern by posting a 20% gain.

The result on equity underwriting obviously had the multiplier effect with the value of equity underwritings mushrooming 154% to $33.3 billion...second only to 1983's incredible $45 billion of equity offering.[7]

That was still an impressive amount especially in the light of 1983 having about twice as many common stock offerings than last year overall, and also double the number of deals in some categories, such as thrift conversions, according to Investment Dealers' Digest.

This rate picture, coupled with proposed tax changes, also catapulted the muni markets. This arena saw an unheard of $241 billion underwritten last year.[8] Not only was that a record, it equalled the sum of the two previous record years together, 1983 and 1984. The net of tax interest rates for munis matched their corporate cousins' decline while nominally shedding 100 basis points as measured by triple-A or Baa G.O. paper or by the Bond Buyer's Index.[9] Though rates were the major factor in all credit markets last year, this doubling of muni volume was helped in no small part by threatened tax legislation affecting interest on municipal securities, caps on municipal borrowings and types of tax-exempt financings.

While rates can explain a rise from $16 billion in corporate debt underwritten in the first quarter to $34 billion in the fourth (with a slightly larger 58% of the year's $105 billion in debt underwritten in the second half[10]), it can't by itself explain what happened to the muni market. According to Investment Dealers' Digest, half of last year's incredible muni volume was underwritten solely in the final quarter, with December alone accounting for one-quarter of 1985's volume.

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[7] Investment Dealers' Digest.

[8] Public Securities Association.

[9] Federal Reserve Bulletin, March 1986.

[10] Investment Dealers' Digest.

Again, much of this activity was an attempt to finance before tax proposals became law, particularly to beat a proposed January 1, 1986 date which might have affected certain municipal financings.

The muni floodgate has now been closed. According to IDD, only a miniscule $11 billion was underwritten in 1986's first quarter. That's less than 5% of last year's total volume. Part of the dearth is explained by municipalities which already completed their immediate financing needs during last year's new issue flood. The other is the tax proposal overhang problem. This scenario was, unfortunately, further exacerbated this year with additional proposals carrying more negative implications. For instance, this March Senate Finance Committee Chairman, Robert Packwood, amended his original proposal to subject muni income to the 20% alternative tax from only newly issued bonds to all existing bonds. This announcement sent a shock wave through the muni markets. It even created a "The Day The Earth Stood Still" atmosphere in muni land on March 19, with trading virtually halted on the Big Board for an hour and several investment banks temporarily shutting down muni activities.[11] However, the proposal was voted down and once the tax picture is finalized the chaotic atmosphere should disappear since, as the adage goes, the markets can handle anything but uncertainty.

On a positive note, though the muni floodgates were shut, the corporate waterfall continues to mirror Niagara with a new quarterly record hitting $68 billion underwritten in this year's first quarter.[12]

## MARGIN INTEREST - EVERY SILVER LINING HAS A CLOUD

With securities industry records being set left and right, something had to be off. Gross margin interest was one of those things. Last year, interest earned on margin accounts in the industry fell 10.3% from $2.9 billion to $2.6 billion. It wasn't that customers weren't buying on margin, in last year's bull market they were doing so at a record clip. According to the NYSE data, average monthly margin debt was up 10.1% last year from $22.7 billion per month in 1984, to $25.0 billion per month in 1985.[13] But this increase was more than offset by the same gremlin which was driving the bull - interest rates. If rates had held up through 1985 at the average 200 basis points higher they were in 1984, margin interest on that $25 billion average monthly debt could have increased margin interest revenue another $500 million. Naturally, such a trend would have impeded the bull market in most securities and all the other wonderful things rate declines did for the industry.

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[11] Wall Street Journal, 3/20/86.

[12] Investment Dealers' Digest.

[13] Based on monthly margin debt reported in NYSE's Marketing Research Report, 3/18/86.

On another positive note, for the first two months of this year, the Bid Board reports monthly margin debt continuing to increase. In January, it was $26.8 billion and then up to $27.5 billion in February.[14]

## OTHER DEPARTMENTS HAD GOOD NEWS TOO

Syndicate managers and principal traders weren't the only ones smiling last year. Revenues from sales of mutual funds skyrocketed and income from this area made even banner year 1983 look anemic by comparison. On a year-to-year basis, this revenue source more than doubled from $751 million in 1984 to $1.6 billion last year. It was also up 72.6% over the very profitable $952 million raked in from these sales in 1983. This source of revenue also increased in importance relative to all revenue sources. Last year, revenue from sales of investment company shares comprised 4.3% of all revenue vs. 3.2% in 1983 and 2.4% in 1984.

In 1984 if it wasn't for the increase of $1.9 billion in revenue related to the securities business, the year would have been in the red. Last year, though up in aggregate, this field was not the same life saver. This income source, generally attributed to M&A activities, private placements and repo activities, increased 14.3% last year to $7.2 billion while total revenues were up 23.7%. Declining interest rates effect on the repo business explains this relatively modest increase. This is similar to what happened to margin interest as a revenue source. Overnight and term repurchase agreements have steadily been rising for years with their best ever quarter being 1985's final one.[15] Yet, declining rates outpaced the growth in this field yielding smaller per dollar returns. Still, these securities related billions are nothing to sneeze at, comprising 18.6% of all revenue last year. That is much better than in 1983 when the $4.4 billion from this source comprised only 14.8% of total revenue and still pretty close to 1984's 20.1% when a majority of other revenue sources either actually declined or fell as a percent of total revenues.

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[14] Based on monthly margin debt reported in NYSE's Marketing Research Report, 3/18/86.

[15] Data Resources, Inc. Review of the U.S. Economy.

Though it may be considered bad luck to knock a 14.3% increase in other securities related revenue, especially when it is contributing 18.5% to total industry revenue, the figure is somewhat disappointing considering the heyday activity which occurred in its three major generating fields.

According to the Chicago-based merger consultant, W.T. Grimm & Co, M&A activity last year was nothing short of phenomenal. The $180 billion of 1985 M&A activity shattered the previous record set in 1984, climbing a staggering 47% from that year's $122 billion. Granted, just over half that volume came from just 36 transactions, each exceeding $1 billion (double the number of those size mega deals in 1984), but the remaining volume came upon a 12-year record in the number of M&A deals, 3001 in total last year.

M&A bankers are cautious that the boom in their field may be over. According to Grimm, once the bull kicked into gear and drove down the number of undervalued target companies, M&A activity waned toward year's end...the fourth quarter showed the least business.

The less than expected 14.3% increase can't be blamed on a weak private placement arena either. According to Investment Dealers' Digest, this area increased 38% last year, going from $53 billion in transactions in 1984 to a new record $73 billion last year. Granted, there is a small universe of securities firms doing a meaningful business in the area.

So lower rates, again, have hurt one revenue source (here repos) while conversely helping others.

## EXPENSES - UNSTOPPABLE FORCE MEETS IMMOVABLE OBJECT

That nemesis of the securities industry, in fact all industries - expenses - were as always, up again last year. The good news, as mentioned earlier, is that in 1985 the industry managed to keep the increase well below its rate of revenue growth. Costs rose 16.6%, compared to a 23.7% revenue gain.

For expenses, as was true with revenues, there was practically a high-point across the board sweep of all categories in the fourth quarter of 1985. Overall, the fourth quarter's expenses aggregated $10.1 billion while in each of the first three quarters the amounts were about $8 billion. Fortunately, revenues outpaced the move jumping to $11.6 billion in the final quarter from about $9 billion each in quarters one through three.

Now for the bad news. As said earlier, when looking at the picture a little longer - two years - last year's expenses were 34.2% higher than the $25.7 billion incurred in 1983. Revenues however, increased at a slightly lower rate over the same time span - 30.4%.

Securities industry profitability, before taxes and any extraordinary gains or losses, was up a hefty 158% in 1985 on a year-to-year basis but only up 7.9% over 1983. But 1983's $3.8 billion of profits were the old record and the industry, despite cost pressures during the latest two years, appears satisfied with the new $4.1 billion pre-tax profit record under its belt (particularly coming after 1984's disappointing profit performance).

After 1984, when expenses comprised 94.8% of total revenue, it was comforting to break below the 90s barrier when 1985 expenses comprised 89.3% of all revenues. Though this reflected an important drop, it was still the second highest proportion of total revenues (or second lowest profit margin) since the late 1970s, when expenses then were also running at better than 90% of revenues. Since then, the cost/revenue ratio ran at 85.9%, 89.2%, 86.9% and 87.1% for years 1980 through 1983, respectively.

What this boils down to is that as a percentage of total revenues, expenses are moving in the right direction - down - but with plenty of room still left for improvement. In other words, the long-run trend of pressure on profit margin remains.

Hopefully, the current market environment allows for such an improvement and the data supports this hope. During the first three quarters of 1985, expenses were rising from around 89% of revenues to 92%. In the last quarter, however, this ratio dropped significantly to 87.3% of revenues. What this shows is that during the current bull market, the industry was able to keep its rising expenses (a natural phenomenon during higher activity periods) significantly under a rising revenue base. Even on a quarter to quarter basis with the final period having a practically across the board sweep in higher expenses in the aggregate, the rises trailed the sweep of revenue gains in the final quarter so that many, though not all, expense categories were showing their lowest quarterly ratio to revenues.

So the industry trend last year was being able to keep more pennies out of each revenue dollar, and most of these additional cents were kept during the bull. Furthermore, since all the trends which made the fourth quarter a winner are still in play today (in some areas even more so), 1986's first quarter should be an even better period.

## PAY CHECKS: LESS PER REVENUE DOLLAR THOUGH HARDLY SCROOGE-LIKE

The securities industry's biggest asset, though off the books, is likewise its biggest expense...people. As always, one of the most costly (although profitable) category of employee is the registered rep. Last year, RR compensation increased to a new record, $6.9 billion representing 17.9% of total revenues in 1985. That is up slightly from a 16.8% share of total revenues in 1984 but 1984 was the only year since the late Seventies when aggregate RR compensation fell from the previous year. A more indicative year to compare that 17.9% ratio was one year further back, 1983's similar bull market. In that period, RR compensation came to a much higher 19.4% of revenues. The basic trend in keeping RR costs from increasing faster than revenues is headed in the right direction and reflects the changing mix of the business. What's further encouraging is that even though this RR ratio went from 17.3% of revenues to 19.2% in the first three quarters of 1985, in the final quarter the registered rep payroll only constituted 16.5% of the period's revenues reflecting gains in the principal business. This trend again bodes well for the current year.

The second largest people expense, which historically is only a neck behind the RR in the payroll race, is clerical and administrative employee expenses. Last year was no exception, the total came to $6.2 billion. This represented 16.1% of revenues, a favorable showing since a higher 16.5% ratio in this area was experienced in each of the two preceding years. Again the fourth quarter's trend was towards a lower bite out of total revenues - only 15.7%, a full percentage point lower than the second and third quarter showings of 16.7% and 16.6% respectively, though a hair over the first quarter's 15.6%.

Even the payroll expense for partners and officers, though breaking through the billion dollar barrier for the first time last year, keeps falling as a percent of total revenues. In 1983 the compensation expense for this category was 3.3% of revenues. In 1984 it fell to just 3.0%. Last year it fell even further to 2.9% and in the final quarter the ratio was down to a mere 2.6%. Therefore, overall, the industry has been able to keep its payroll expense increase in line, and even below, its revenue growth.

## INTEREST EXPENSE WENT UP DESPITE RATES GOING DOWN

One other significant expense category is interest expense. And significant it was. Last year this expense broke the $10 billion barrier for the first time and nearly doubled the level of three years earlier.

At first blush something seems to be wrong. With interest rates spiralling downward why would this category be eating up 26.2% of revenues in 1985 when it only accounted for 20.5% two years earlier and even increased to 27.6%, its highest level, in the last quarter? The answer is simple...the securities industry has been borrowing to the hilt. Total liabilities more than doubled from $146.5 billion in 1983's first quarter to $377.2 billion at last year's close. But this is a leverage strategem and it is working. If the industry can generate a 30.4% revenue increase in two years (1983-1985) to record levels and record profits, is a 5.7%[16] bigger bite out of total revenues a high price to pay? If we think of interest expense as a function of total liabilities there has actually been a decline in relative interest expenses. The $10.1 billion in interest expense incurred last year was only 3.5% of 1985's average liabilities of $287 billion.[17] That's much better than in 1984 when it comprised 4.3% of average liabilities and even slightly better than in 1983 when the ratio was 3.6%.

## KEEPING YOUR (OVER)HEAD ABOVE WATER

Given the very cyclical and service oriented nature of the securities business, fixed expenses, or overhead, are anything but fixed. Like everything else, they keep going up. What the industry wants to see is that they go up slower than revenues do, cutting less from the bottom line.

Communications costs, which include phone bills, quote machines, stationary and stamps, have followed the increases in the underlying rates from the Ma Bell, the Baby Bells and the Post Office suppliers of these services...up. These are also activity related (traders are on the horn a lot more during the bull) and the half billion dollars incurred for communications during 1985's last quarter underscores this fact (prior to 1981 no full year came to $1 billion in this area). Again the good news is that though this field is up in aggregate, it keeps taking a smaller part of industry revenues. The $1.9 billion of communications costs last year was only 5.0% of revenues, down from 5.2% and 5.7% in 1983 and 1984, respectively. It also bottomed out at a mere 4.2% in the final quarter, though that period was the highest in actual dollars. Basically, the industry seems to be getting more revenues per phone call, quote or letter it sends.

Occupancy and equipment rental expenses, which include rent, heat, lighting, maintenance, depreciation and EDP equipment rentals, are a little more tricky to look at from year to year. Some of its factors, particularly depreciation, rent and equipment rental, have a built in lag time factor. Gearing-up in 1983 to handle heavy bull market loads will more

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[16] Interest expense as a percent of total revenues in 1985, 26.2%, vs 1983, 20.5%.

[17] Reflects a five period average: the year's beginning balance and the ending balances in each of the four quarters.

## Table 5

### BALANCE SHEET
### TOTAL SECURITIES INDUSTRY AT DECEMBER 31
(In $ millions)

| | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 |
|---|---|---|---|---|---|---|
| ASSETS | | | | | | |
| Cash | 884.7 | 971.0 | 1937.7 | 1654.6 | 2291.9 | 3798.3 |
| Segregated Cash | 1454.6 | 1336.0 | 2006.7 | 1369.8 | 1162.9 | 1642.4 |
| Receivables from Brokers, Dealers, and Clearing Organizations | 11614.4 | 12371.9 | 20437.6 | 24716.2 | 26016.1 | 50503.5 |
| Receivables from Customers | 22697.6 | 20777.6 | 23728.2 | 31767.3 | 29093.3 | 45192.4 |
| Receivables from Non-customers | 1022.8 | 979.2 | 745.4 | 1215.3 | 1140.7 | 2243.4 |
| Securities Purchased Under Agreement to Resell | 31015.1 | 42436.5 | 51475.7 | 74903.4 | 104409.3 | 136148.2 |
| Securities & Spot Commodities Owned | 29449.7 | 37505.7 | 65314.1 | 70393.8 | 100643.1 | 139825.7 |
| Securities Owned not Readily Marketable | 77.0 | 33.6 | 49.0 | 91.9 | 385.2 | 143.9 |
| Other Investments not Readily Marketable | 31.6 | 43.0 | 38.7 | 52.5 | 60.5 | 61.4 |
| Securities Borrowed (subordinated & partner's accounts) | 84.7 | 84.7 | 70.8 | 78.0 | 39.8 | 30.7 |
| Secured Demand Notes | 269.6 | 238.3 | 242.7 | 256.6 | 340.1 | 323.1 |
| Memberships in Exchanges | 177.1 | 179.5 | 210.8 | 237.9 | 246.6 | 258.0 |
| Investments in/Receivables from Affiliates,Subs & Assoc. Partnerships | 435.3 | 698.1 | 1148.1 | 1667.0 | 2024.5 | 2613.6 |
| Property, Furniture, Equipment, etc. | 504.8 | 909.2 | 1413.8 | 1860.7 | 2235.9 | 2546.8 |
| Other Assets | 2519.2 | 3044.0 | 3617.8 | 4915.6 | 5901.8 | 8490.3 |
| Total Assets | 102256.7 | 121625.1 | 172436.8 | 215180.4 | 275992.1 | 393801.7 |
| LIABILITIES | | | | | | |
| Bank Loans Payable | 8514.2 | 10286.3 | 9551.2 | 18440.8 | 25136.4 | 37423.8 |
| Securities Sold Under Repurchase Agreements | 32173.6 | 51693.1 | 74833.5 | 86179.7 | 130051.9 | 158867.1 |
| Payable to Brokers, Dealers, and Clearing Organizations | 10883.8 | 11247.6 | 19171.3 | 20610.4 | 21177.0 | 44571.5 |
| Payable to Customers | 14333.4 | 12517.7 | 15785.9 | 18460.0 | 19217.4 | 30561.0 |
| Payable to Non-customers | 743.2 | 827.4 | 772.9 | 1270.5 | 1227.7 | 2608.9 |
| Securities Sold, Not Yet Purchased | 20536.0 | 17736.8 | 28896.5 | 38785.6 | 44194.2 | 71458.0 |
| Accounts Payable and Accruals | 8088.8 | 8765.0 | 11971.2 | 16219.1 | 16619.3 | 24075.0 |
| Notes and Mortgages Payable | 148.7 | 384.4 | 641.4 | 914.6 | 1448.6 | 2176.8 |
| Subordinated Liabilities | 1365.8 | 1377.6 | 1741.3 | 2389.5 | 3932.1 | 5285.3 |
| Total Liabilities | 96899.6 | 114926.9 | 163467.6 | 203385.9 | 263177.6 | 377165.5 |
| OWNERSHIP EQUITY | | | | | | |
| Sole Proprietorship | 1.7 | 10.1 | 3.3 | 7.5 | 0.9 | 43.4 |
| Partnership-Limited Partners | 1755.6 | 1641.3 | 2324.5 | 2895.4 | 3017.8 | 3171.4 |
| Corporation | | | | | | |
| Preferred Stock | 79.5 | 49.8 | 42.5 | 45.7 | 53.1 | 680.5 |
| Common Stock | 91.7 | 433.2 | 488.1 | 508.0 | 532.8 | 606.5 |
| Add. Paid-in Capital | 1251.3 | 1692.2 | 2312.5 | 3207.8 | 4080.1 | 5671.1 |
| Retained Earnings | 2222.2 | 2895.5 | 3850.4 | 5160.0 | 5162.6 | 6514.6 |
| Corporation Total | 3644.7 | 5070.7 | 6693.6 | 8921.5 | 9828.4 | 13473.6 |
| Less Capital Stock In Treasury | -44.8 | -40.4 | -53.4 | -29.5 | -32.3 | -32.0 |
| Total Ownership Equity | 5357.2 | 6680.0 | 8969.8 | 11796.5 | 12814.7 | 16651.2 |
| Total Liabilities and Ownership Equity | 102256.7 | 121625.1 | 172436.8 | 215180.8 | 275991.1 | 393932.6 |

likely show up as increased expenses in following years. The full impact of adding more space will be reflected in following years' lease and rental figures as would the depreciation of added new equipment and EDP equipment rental fees.

In 1984, for example, this expense category jumped both in aggregate, $1.1 billion to $1.5 billion, and took a bigger slice of total revenues, 4.8% vs. 1983's 3.9%. However, last year's $1.8 billion occupancy and equipment expense used up a slightly smaller (than 1984) 4.7% of revenues, with the fourth quarter using the least of all quarters, 4.3%. Some other factors which helped keep last year's expenses down and should also help even more in 1986 are reduced heating and lighting costs, with oil prices plummetting, plus minimal inflation rates.

## THE BALANCING ACT

The total industry's balance sheet (again from NYSE firms doing a public business) has exploded in just a few years. At 1983's onset, the industry boasted assets of $172.4 billion. By last year's close, that had mushroomed 128% to $393.8 billion. Most of the growth was leveraged. Total liabilities over the same time frame grew 130% to $377.2 billion as of December 31, 1985. Total ownership equity, while having expanded to a record $16.7 billion as of that date, grew at a smaller 86% rate over the same period.

Total ownership equity barely grew from 1983's close to 1984's end, up $1 billion or 8.5%. However, from that point on until the end of 1985, the increase blossomed $3.9 billion or 30.5%. Practically the entire increase occurred in last year's final quarter. During those three months, three categories of equity were substantially increased and accounted for the bulk of the year's total increase. Preferred stock outstanding, having hovered in the $40 to $50 million range since 1983's start, grew to just under $80 million in the second and third quarters of 1985 and then shot through the roof, topping out at $681 million as of December 31. That was a 1,185% year-to-year increase. Common stock equity (par value plus paid in capital) has grown from $2.8 billion as 1983 began to $6.7 billion at 1985's close. Amazingly, $2 billion of that increase came in fourth quarter, 1985. Retained earnings, which rose from about $4 billion at 1983's start to $5.2 billion at 1985's start, jumped another $1.3 billion last year with half that gain coming in the final quarter.

Half of last year's $1.7 billion increase in common stock equity (including paid in capital) came from eight new issues of stock through public underwritings and private placements, according to Investment Dealers' Digest. The bulk of the remaining half, particularly in light of the preponderance of the increase coming in the fourth quarter, is mainly attributed to a lot of stock option exercising to capitalize on the market

## Table 6

### 1985 QUARTERLY BALANCE SHEET
### TOTAL SECURITIES INDUSTRY
(In $ millions on last day of quarter)

| | 1985:1 | 1985:2 | 1985:3 | 1985:4 |
|---|---|---|---|---|
| ASSETS | | | | |
| Cash | 2044.5 | 1951.4 | 2303.6 | 3798.3 |
| Segregated Cash | 1377.2 | 1221.5 | 1218.6 | 1642.4 |
| Receivables from Brokers, Dealers, and Clearing Organizations | 27659.0 | 33079.9 | 32582.4 | 50503.5 |
| Receivables from Customers | 27768.8 | 33464.6 | 35729.5 | 45192.4 |
| Receivables from Non-customers | 982.2 | 1313.1 | 1116.9 | 2243.4 |
| Securities Purchased Under Agreement to Resell | 102610.3 | 104856.4 | 111150.0 | 136148.2 |
| Securities & Spot Commodities Owned | 81374.2 | 95140.7 | 102126.7 | 139825.7 |
| Securities Owned not Readily Marketable | 199.1 | 146.4 | 152.2 | 143.9 |
| Other Investments not Readily Marketable | 53.8 | 54.8 | 60.3 | 61.4 |
| Securities Borrowed (subordinated & partner's accounts) | 43.4 | 46.7 | 25.0 | 30.7 |
| Secured Demand Notes | 317.1 | 315.3 | 309.6 | 323.1 |
| Memberships in Exchanges | 248.9 | 244.3 | 246.9 | 258.0 |
| Investments in/Receivables from Affiliates,Subs & Assoc. Partnerships | 2074.5 | 2221.8 | 2737.7 | 2613.6 |
| Property, Furniture, Equipment, etc. | 2283.8 | 2132.3 | 2148.7 | 2546.8 |
| Other Assets | 5631.9 | 6160.7 | 6760.8 | 8490.3 |
| Total Assets | 254668.8 | 282350.4 | 298669.4 | 393801.7 |
| LIABILITIES | | | | |
| Bank Loans Payable | 19229.0 | 26676.6 | 26640.0 | 37423.8 |
| Securities Sold Under Repurchase Agreements | 112778.4 | 117940.5 | 126782.9 | 158867.1 |
| Payable to Brokers, Dealers, and Clearing Organizations | 24729.9 | 28728.6 | 28479.7 | 44571.5 |
| Payable to Customers | 18627.0 | 22310.6 | 22442.8 | 30561.0 |
| Payable to Non-customers | 1128.8 | 1184.2 | 1135.5 | 2608.9 |
| Securities Sold, Not Yet Purchased | 47028.0 | 51126.3 | 55399.0 | 71458.0 |
| Accounts Payable and Accruals | 13590.5 | 15704.4 | 18074.8 | 24075.0 |
| Notes and Mortgages Payable | 682.8 | 749.2 | 883.3 | 2176.8 |
| Subordinated Liabilities | 3818.4 | 4114.7 | 4445.3 | 5285.3 |
| Total Liabilities | 241732.0 | 268636.0 | 284382.4 | 377165.5 |
| OWNERSHIP EQUITY | | | | |
| Sole Proprietorship | 0.4 | 0.0 | 1.6 | 43.4 |
| Partnership-Limited Partners | 3111.0 | 3363.0 | 3509.3 | 3171.4 |
| Corporation | | | | |
| Preferred Stock | 36.1 | 76.6 | 78.7 | 680.5 |
| Common Stock | 530.6 | 576.2 | 571.8 | 606.5 |
| Add. Paid-in Capital | 3904.9 | 3974.0 | 4253.0 | 5671.1 |
| Retained Earnings | 5389.9 | 5850.7 | 5907.0 | 6514.6 |
| Corporation Total | 9861.3 | 10477.3 | 10810.6 | 13473.6 |
| Less Capital Stock In Treasury | -33.9 | -37.6 | -33.9 | -32.0 |
| Total Ownership Equity | 12936.9 | 13714.2 | 14299.8 | 16651.2 |
| Total Liabilities and Ownership Equity | 254668.9 | 282350.4 | 298669.2 | 393932.6 |

run-up. Securities firm stocks were continuously posting new 52-week and all time highs during the quarter and the time was ripe for exercising these options. However, a single $75 million sale of preferred only made up a fraction of last year's $627 million increase in preferred equity but the balance was likewise assumed to have come from internal capital infusions.

## A RETURN TO RETURN ON EQUITY

As a group, the securities industry is now headed back to levels of profitability comparable to its best years of the past.

The return on equity[18] earned last year easily outpaced 1984's poor showing. On a pre-tax basis, 1985's 29.4% ROE outdistanced by a few furlongs 1984's 13.3% showing, the worst in recent memory. Nevertheless, it did not match the 36% to 41% return in the other three years since phenomenal 1980 (that year a 49.2% pre-tax ROE). However, as said earlier, the profitability rebirth began in the fourth quarter and continues to date. In that period, pre-tax ROE jumped to 38.1%, clearly in line with the three best years since 1980.

On an after-tax basis the trend again bodes well for 1986. Last year's 15.9% ROE also left 1984's rate in the dust, then a meager 7.2%. The final quarter last year once again shows a marked improvement in this area - up to 20.6%, right in line with the 19% to 22% returns shown in years 1981 through 1983.

Moreover, this return on equity had to be earned on an increasingly larger equity basis. As said earlier, over a 36 month period (January 1, 1983 through December 31, 1985) the total equity ownership base jumped 86% to $16.7 billion.

Other measures of profitability followed suit. As briefly discussed earlier under revenues and expenses, the industry's profit margin, both on a pre-tax and after-tax basis, has rebounded back from 1984's depths and in the final quarter shot up even further to match the levels of the early 1980s.

## NOW THAT WE'RE HERE, WHERE ARE WE GOING?

What the previously discussed increases mean, and the industry certainly hopes will be borne out, is that all the

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[18] Annual ROE is determined by net income divided by a (five period) average total equity (the year's opening balance plus the four quarterly closing balances). Quarterly ROE is determined by an annualized net income divided by a (two period) average total equity (the quarter's opening and closing balance.

## Table 7

### RATIO REPORT
### TOTAL SECURITIES INDUSTRY

| | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 |
|---|---|---|---|---|---|---|
| PROFITABILITY (%-Annualized) | | | | | | |
| Profit Margin-Pre-Tax | 14.1 | 10.8 | 13.1 | 12.9 | 5.2 | 10.7 |
| Profit Margin-After Tax | 7.6 | 5.8 | 7.1 | 7.0 | 2.8 | 5.8 |
| ROA-Pre-Tax | 2.8 | 2.1 | 2.3 | 2.1 | 0.7 | 1.4 |
| ROA-After Tax | 1.5 | 1.1 | 1.3 | 1.1 | 0.4 | 0.7 |
| ROE-Pre-Tax | 49.2 | 35.9 | 40.5 | 36.6 | 13.3 | 29.4 |
| ROE-After Tax | 26.6 | 19.4 | 21.9 | 19.8 | 7.2 | 15.9 |
| Earnings Growth (%Ch, Year-ago) | 105.7 | -5.2 | 41.5 | 26.0 | -57.9 | 157.5 |
| PRODUCTIVITY (Annualized) | | | | | | |
| Asset Turnover | 0.20 | 0.19 | 0.18 | 0.16 | 0.13 | 0.13 |
| Capital Turnover | 2.77 | 2.72 | 2.59 | 2.37 | 2.03 | 2.10 |
| Revenue Per Employee | 114,641 | 123,242 | 135,758 | 154,016 | 150,455 | 179,951 |
| LEVERAGE (Ratios) | | | | | | |
| Equity to Total Capital | 0.797 | 0.829 | 0.837 | 0.832 | 0.765 | 0.759 |
| Equity to Total Assets | 0.052 | 0.055 | 0.052 | 0.055 | 0.046 | 0.042 |
| Short to Long Positions | 0.697 | 0.473 | 0.442 | 0.551 | 0.439 | 0.511 |

### RATIO REPORT
### TOTAL SECURITIES INDUSTRY

| | 1985:1 | 1985:2 | 1985:3 | 1985:4 |
|---|---|---|---|---|
| PROFITABILITY (%-Annualized) | | | | |
| Profit Margin-Pre-Tax | 10.4 | 11.1 | 8.0 | 12.7 |
| Profit Margin-After Tax | 5.6 | 6.0 | 4.3 | 6.9 |
| ROA-Pre-Tax | 1.4 | 1.5 | 1.0 | 1.7 |
| ROA-After Tax-Pre-Tax | 0.8 | 0.8 | 0.5 | 0.9 |
| ROE - Pre-Tax | 29.0 | 30.8 | 20.2 | 38.1 |
| ROE - After-Tax | 15.7 | 16.6 | 10.9 | 20.6 |
| Earnings Growth (%Ch, Year-ago) | 82.8 | NM | 2.2 | 193.3 |
| PRODUCTIVITY (Annualized) | | | | |
| Asset Turnover | 0.13 | 0.14 | 0.12 | 0.13 |
| Capital Turnover | 2.14 | 2.14 | 1.93 | 2.28 |
| Revenue Per Employee | 172,497 | 174,751 | 162,597 | 209,902 |
| LEVERAGE (Ratios) | | | | |
| Equity to Total Capital | 0.772 | 0.769 | 0.763 | 0.759 |
| Equity to Total Assets | 0.051 | 0.049 | 0.048 | 0.042 |
| Short to Long Positions | 0.578 | 0.537 | 0.542 | 0.511 |

factors in last year's final months that have elevated the securities industry back to its former profitability days are in place this year and are driving the industry towards its possibly best ever showing. Certainly 1986's first quarter is now expected to be one of, if not the best, quarter ever for the industry as a whole.

Some factors to watch this year are:

1. Interest rates: their continuing decline is fueling both the primary and secondary corporate debt and equity markets. Corporate bond underwritings continue at a record breaking clip while equity, though not yet at 1983's torrid pace, is still incredibly strong. The secondary trading markets for bonds and equity are mirroring their primary market cousins. These factors will determine how the industry's commission and trading gain revenues will fare.

2. Equity markets: the run-up in this area has been fast and steep and though driven by favorable economic and rate environments it is still a fragile customer towards psychology and thus could come to an abrupt halt. Continued gains here will help trading profits and commissions but hurt M&A activity since it dries up the pool of undervalued target companies.

3. Washington: proposed tax legislation is often as damaging as its enactment. The municipal market already learned this lesson. The Eurobond business may be in for a jolt if a withholding tax is reimposed. Additional 20% minimum tax proposals are again troublesome to the muni market.

4. Overcapacity: every time the market goes wild, as it has been recently, securities firms add capacity in the form of RRs, equipment and work space. Then when it goes bust its cut-back time again.

5. Balancing opposing forces: just because your RRs margin accounts are active and way up don't assume your revenue is increasing. Falling rates, as seen earlier, have kept revenues from this field from matching the increased activity in it. The same is true with commissions. Though trading is heavier, reduced commission rates have prevented revenues from keeping pace with the added activity.

Though there are always pitfalls along the road, based on how the year just past signed off, this year's path for the industry in general may prove to be a rosy one indeed.

George R. Monahan
Assistant Director
of Research

VOLUME

| | FEBRUARY 1986 | JAN - FEB 1986 | FEBRUARY 1985 | JAN - FEB 1985 | % CHAN. J-F 1986-1985 |
|---|---|---|---|---|---|
| AVERAGE DAILY SHARE VOLUME ON | | | | | |
| NYSE (MILS.)* | 152.6 | 141.8 | 115.5 | 118.5 | 19.6% |
| AMEX (MILS.)* | 14.0 | 12.6 | 10.3 | 9.7 | 29.4% |
| NASDAQ (MILS.)* | 121.9 | 115.8 | 91.2 | 87.7 | 32.1% |
| REGIONAL EXCHANGE (MILS.)* | 25.3 | 23.8 | 20.0 | 19.7 | 21.1% |
| DOLLAR VALUE OF SHARES TRADED ON | | | | | |
| NYSE (MILS.) | $108,415 | $213,425 | $76,036 | $165,271 | 29.1% |
| AMEX (MILS.) | 2,654 | 5,712 | 2,630 | 4,560 | 25.3% |
| ODD-LOT SHARES PURCHASED ON NYSE (THOUS.) | 8,250 | 16,519 | 6,273 | 13,757 | 20.1% |
| ODD-LOT SHARES SOLD (INCLUDING SHORT SALES) ON NYSE (THOUS.) | 19,145 | 37,734 | 15,436 | 33,106 | 14.0% |
| NYSE BLOCK VOLUME AS A PERCENT OF TOTAL SHARES TRADED | 49.6% | 49.6% | 50.7% | 51.0% | ---- |
| CONTRACTS TRADED (THOUS.) | | | | | |
| CBOE OPTIONS | 15,851 | 31,077 | 11,228 | 25,176 | 23.4% |
| AMEX OPTIONS | 4,905 | 10,478 | 2,866 | 6,217 | 68.5% |
| COMMODITY | 15,764 | 32,043 | 12,812 | 26,065 | 22.9% |

*MONTHLY AVERAGE
N/A - DATA NOT AVAILABLE

## YIELDS

(MONTHLY AVERAGES)

| | MARCH 1986 | MARCH 1985 | BASIS POINT CHG 1986-1985 |
|---|---|---|---|
| BOND BUYER INDEX (20 BOND) | 7.44% | 9.65% | (221) |
| CORPORATE BOND YIELDS (MOODY'S) | | | |
| Aaa CORPORATE | 9.67 | 12.13 | (246) |
| Baa CORPORATE | 11.11 | 13.23 | (212) |
| RATIO Aaa CORPS. TO Baa CORPS. | 0.87 | 0.92 | (5) |
| MUNICIPAL BOND YIELDS (MOODY'S) | 7.44 | 9.65 | (221) |

## PRICES

(END OF MONTH)

| | MARCH 1986 | MARCH 1985 | % CHAN. Y-T-D 1986-1985 |
|---|---|---|---|
| DOW JONES INDUSTRIALS | 1818.61 | 1266.78 | 43.56% |
| STANDARD & POOR'S 500 | 238.9 | 180.66 | 32.24% |
| NYSE COMPOSITE | 137.71 | 104.6 | 31.65% |
| AMEX MARKET VALUE INDEX | 270.03 | 229.59 | 17.61% |
| VALUE LINE COMPOSITE | 242.23 | 194.53 | 24.52% |
| NASDAQ COMPOSITE | 374.72 | 279.2 | 34.21% |

## UNDERWRITING

| | FIRST QUARTER 1986 | FIRST QUARTER 1985 | 1ST Q'86-1ST Q'85 % Change 1986-1985 |
|---|---|---|---|
| CORPORATE FINANCING (Gross New Issues - Millions) | | | |
| TOTAL | 68.0 | 21.3 | 219.2% |
| Common Stock | 8.7 | 4.3 | 102.3% |
| # of Common Stock Issues | 205 | 128 | 60.2% |
| Preferred Stock | 3.8 | 1.0 | 280.0% |
| # of Preferred Stock Issues | 39 | 15 | 160.0% |
| Corporate Debt | 55.5 | 15.9 | 249.1% |
| # of Corporate Debt Issues | 543 | 232 | 134.1% |
| MUNICIPAL FINANCING (Gross New Issues - Millions) | | | |
| Notes | N/A | N/A | N/A |
| Bonds | 11,351 | 21,737 | -47.8% |

Source: IDD and Salomon Brothers

## MARGIN DEBT

| | FEBRUARY 1986 | FEBRUARY 1986 | % CHANGE 1986-1985 |
|---|---|---|---|
| MARGIN DEBT OUTSTANDING ($MILS) | 27,450 | 22,970 | 19.5% |
| NET CHANGE IN MARGIN DEBT ($MILS) | 4,480 | 640 | 600.0% |
| % OF ACCOUNTS WITH EQUITY UNDER 40% | 10% | 10% | ----- |

# RECENT INTERESTING READING AND STATISTICAL MATERIAL

| Item | Description | Source |
|---|---|---|
| Transcript of SIA's 7th Annual Trends Conference on Distribution and Changing Customer Needs | A complete transcript of speakers at the 1/22/86 Conference including all the tables and charts presented. Topics on current and future distribution techniques discussed at the conference ranged from retail, institutional and international distribution problems and trends to discounting and technology's role in distribution strategies. | SIA<br>Cost: $75 |
| "First Quarter Domestic Corporate Financing 1986" | A quarterly record $68 billion in corporate underwritings were completed in 1986's Q1. Salomon Brothers again topped the manager rankings. Contained is a complete listing of top 15 book managers of these financings, with Q1 1986 compared to Q1 1985. | Investment Dealers' Digest, 4/7/86<br>150 Broadway<br>New York, NY 10038 |
| "Salomon's Power Culture" | This story characterizes Salomon Brothers as an anomaly, albeit a rich and powerful one, in investment bank management style.. Besides labeling the firm a "trading oriented" culture, the article alternately portrays the firm's captain, John Gutfreund, as a self-effacing laid-back soul to that of a shrewd businessman who wrested control of Salomon from Phibro CEO David Tendler less than five years after Phibro bought Salomon out. Good reading for both Salomon insiders and outsiders. | Institutional Investor, 3/86<br>488 Madison Avenue<br>New York, NY 10022 |

| | | |
|---|---|---|
| "The New Wave of Corporate Raiders" | Article dealing with the likely successors to the Irwin Jacobs and T. Boone Pickins of this world. Story identifies and categorizes a good list of takeover artists giving their track record, methodology and styles. | Financial World, 4/1/86<br>1450 Broadway<br>New York, NY 10018 |
| "Financing Techniques: What's Hot, What's Not" | Atricle dealing with what financing techniques are heating up in the corporate primary market and what ones are cooling off. For each category, such as the "hot" medium-term notes and the "not hot" yield curve notes, the story shows how many deals and for how much, the frequent underwriters, and how the deals work. Also, their "hot" or "cold" status and examples of recent issues are contained. | Investment Dealers' Digest, 3/17/86<br>150 Broadway<br>New York, NY 10038 |
| The Future of Technology in the Financial Services Industry | A study outlining the great impact electronic technology has made on the financial services industry and key issues which are of concern today such as computer security, executive comfort with technology planning and technology's strategic advantage. Commissioned by C&L, the study was conducted through interviews with 250 top executives in the nations largest brokerage firms, investment companies, syndicators, insurance companies and commercial banks. | Coopers & Lybrand<br>1251 Avenue of the Americas<br>New York, NY 10020 |
| "Bank Supervision in a Changing Financial Environment" | On 1/30/86, Federal Reserve Bank of New York President E. Gerald Corrigan addressed the New York State Bankers Association on the topic of what the New York Fed saw as a need to strengthen the supervision of banking organizations. This is a transcript of his address. | Federal Reserve Bank of New York Quarterly Review, Winter 1985-86<br>33 Liberty Street<br>New York, NY 10045 |
| More Words of Wall Street | A sequal to the original and popular "Words of Wall Street" published in 1983. The new dictionary will list approximately 2,000 Wall Street jargon words, most not included in the 2,000 from the original version. | To be available in bookstores this summer |

* * * SPECIAL OFFER * * *

You may now order copies of the Transcript of the 1985 Trends Conference: Keys to a Changing Securities Industry at the greatly reduced price of $15.00 per copy. The Conference focused on the results of the Delphi study on the impact of today's major trends on the securities industry in the late 1980s. The transcript includes an in-depth analytical presentation of the results of the study and panelists' speeches on the implications of these results for specific segments of the business. Topics covered include: cost control, opportunities and concerns of the 1980s, the retail securities business and competition. To obtain a copy, please use the order form below.

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AN ANALYSIS OF EMERGING TRENDS IN THE SECURITIES INDUSTRY
Produced by the SIA Research Department

A8825-1

Vol. XII, No.5 May 1, 1986

## SIA TRENDS FLASH....1986's STELLAR START

Individual firm first quarter reports and gut reactions have already fostered much speculation that this year's first quarter smashed plenty of records (and with a big hammer) for the securities industry. Speculation is no longer needed.

The first quarter is now THE record quarter for securities industry profits based on preliminary data which represents the majority of the industry's revenues and profits. This data shows a torrid level of business for the first quarter.

Based on the top 15 NYSE firms doing a public business (which ~~in~~ recent times account for about half of all revenues) the industry posted a $2 billion first quarter pre-tax net profit. That is a third better than 1985's then second best ever quarterly showing of $1.5 billion in Q4; is half of all of full year 1985's pre-tax profits ($4 billion); and is even 25% better than the previous $1.6 billion quarterly record profit turned in during the final three months of 1982.

This $2 billion industry pre-tax net income projection was determined by comparing the top 15's share of total industry revenues, expenses and profits for full year 1985 and fourth quarter 1985 and applying those comparisons to the 15's showing in this year's first quarter. The $2 billion is an average of the four methods described below and is probably conservative since higher showings are reflected in the fourth quarter bull market of which this year's first quarter is very similar. The first quarter was not only similar, but even better based on many factors including individual firm's quarterly reports, market indices and corporate financing record activity.

Comparing on the annual basis, the industry shows estimated first quarter revenues of $12.6 billion. This is derived by applying the top 15 firms' 1985 46.5% share of all revenues to their 1986 Q1 $5.9 billion record revenue showing. Likewise, by applying their 1985 share of expenses to their $5.2 billion

1986 Q1 expenses, the industry is projected to incur $10.9 billion of expenses in Q1. That leaves a pre-tax industry profit of $1.7 billion for the first quarter. If we apply the top 15's 38.5% share of pre-tax profits last year to their $680 million Q1 pre-tax showing, the industry's pre-tax profit projection rises slightly to $1.8 billion.

But projections based on the top 15's 1985 fourth quarter share of revenues, expenses and profits, which as said was more indicative of the first quarter's atmosphere, show industry profits at a much higher level. Industry revenues jump to $13.5 billion based on the share the top 15 garnered in last year's final quarter. In the same manner, expenses amount to $11.3 billion. That leaves a $2.2 billion first quarter pre-tax net income for the industry. Even higher, based on the 27.5% share of pre-tax net the top 15 gleaned in 1985 Q4, total industry before tax profits rise to $2.5 billion.

Averaging the four projected profit figures out gives us a new record $2 billion pre-tax profit for the securities industry in this year's very fine first quarter.

Again, with all the favorable reports issued for the quarter, the $2 billion may prove to be conservative and the higher $2.5 billion projection could become the industry's new quarterly record profit benchmark.

## PROJECTED 1986 Q1 SECURITIES INDUSTRY PROFITS
(In $ Millions)

| | Top 15 | Actual Industry | % | Top 15 | Projected Industry* |
|---|---|---|---|---|---|
| | BASED ON Q4 1985 | | | Q1 1986 | |
| REVENUES | 5,050 | 11,597 | 43.5 | 5,863 | 13,478 |
| EXPENSES | 4,643 | 10,123 | 45.9 | 5,184 | 11,294 |
| PRE-TAX NET | - | - | - | - | 2,184 |
| PRE-TAX NET** | 406 | 1,474 | 27.5 | 680 | 2,473 |
| | BASED ON FULL YEAR 1985 | | | | |
| REVENUES | 17,964 | 38,621 | 46.5 | 5,863 | 12,609 |
| EXPENSES | 16,371 | 34,481 | 47.5 | 5,184 | 10,914 |
| PRE-TAX NET | - | - | - | - | 1,695 |
| PRE-TAX NET** | 1,592 | 4,140 | 38.5 | 680 | 1,766 |
| AVG PRE-TAX NET | | | | | 2,030 |

* Applies the prior period Top 15 share of market to their Q1 1986 results. Also, subtracts projected expenses from projected revenue.

** Differences due to rounding.

George R. Monahan
Assistant Director
of Research

Securities Industry Trends

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AN ANALYSIS OF EMERGING TRENDS IN THE SECURITIES INDUSTRY
Produced by the SIA Research Department

Vol. XII, No. 6 May 30, 1986

A8825-1

## CHARTING A COURSE FOR THE FUTURE: HOW DIFFERENT FIRM CATEGORIES NAVIGATED A PROFITABLE 1985

Following a record year and a record first quarter start for the securities industry as a whole, it would seem hard to find any albatrosses circling this ocean of black ink. But it all depends on whose ship you're on. From the decks of the U.S.S. Large Investment Bank, there appeared nothing but blue sky on the horizon. The same could be seen from the U.S.S. Commission Introducing, but an albatross or two were discernable from the crow's nest. For the New York City and Regional navies, the deck hands were still busy scattering these pests which perched on their bows from the voyage of the early Eighties. And for the National Full Line armada, the ships were still listing from their passage through the choppy straights of 1984.

### HIGHLIGHTS

1. The securities industry's 1985 record pre-tax profits was gratis of the 10 large investment banks and a small group of "other" securities houses which achieved record profits last year. The National Full Line, Regionals, Discounters, Commission Introducing and New York City Based firms all had better profits in 1983.

2. The 20 NFL and LIB firms, which make up 5% of all NYSE firms doing a public business, accounted for three-quarters of this group's revenues and two-thirds of its profits.

3. While concentration marches on at the top of the securities industry pyramid, the small "other" group at the bottom is also chipping away at the middle group's market share.

4. Even though the industry showed record profits in 1985, profit margins were still being squeezed. Two firm categories were actually pinched: NFLs, albeit the perennial low show, have trailed even the U.S. manufacturing industries' low margins for the last two years while NYSE Discounters since 1984 have trailed the industry in profit margins and last year managed to outpace only the NFLs.

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## CONCENTRATION'S CONTINUED MARCH

### But Not All The Non-Majors Are Losing

The securities industry giants last year again left a dwindling slice of the industry's revenue and profit party cake for the rest of the group. It must be remembered, though, that revenues aren't everything. A lot of the non-giants had much better ROEs than their bigger brethren. Still, for the non-25-largest capitalized firms, which account for about 94% of the group, their share of industry revenues has consistently and radically fallen over the last seven years. In 1979 this majority swath of the industry accounted for about one-third of all revenues (32.7%). This steadily declined through the Eighties by 10 percentage points to where last year they only garnered 22.8% of the industry's revenues.

This isn't to say that their aggregate revenues are declining. In fact, they have more than doubled over the same time span to $8.8 billion. What it does show is how the bigger capitalized firms have been able to foster a much faster revenue growth rate.

Table 1

Securities Industry Concentration, 1979-1985

| | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 |
|---|---|---|---|---|---|---|---|
| Total Revenues | | | | | | | |
| Top 10 | 48.7% | 53.1% | 55.6% | 57.3% | 54.4% | 58.8% | 57.5% |
| Top 11-25 | 18.6 | 19.4 | 18.7 | 18.7 | 19.6 | 17.1 | 19.7 |
| Rest of Industry | 32.7 | 27.5 | 25.7 | 24.0 | 26.0 | 24.1 | 22.8 |
| | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% |
| Total Capital | | | | | | | |
| Top 10 | 45.8% | 50.8% | 50.0% | 54.8% | 52.8% | 57.2% | 63.2% |
| Top 11-25 | 18.8 | 18.0 | 19.7 | 18.3 | 18.8 | 15.6 | 14.8 |
| Rest of Industry | 35.4 | 31.2 | 30.3 | 26.9 | 28.4 | 27.2 | 22.0 |
| | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% |

Note: Firm rankings are by capital and change from one year to another.
Source: Securities Industry Database

## Table 2

## STATEMENT OF INCOME
## TOTAL SECURITIES INDUSTRY
## (In $ millions)

| | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 |
|---|---|---|---|---|---|---|
| **REVENUE** | | | | | | |
| Commissions | 5682.1 | 5339.6 | 6011.9 | 8350.2 | 7094.6 | 8235.4 |
| Listed Equities, On an Exchange | 4237.5 | 3954.7 | 4484.1 | 6131.5 | 5232.6 | 6069.8 |
| Listed Equities, OTC | 44.6 | 72.8 | 61.0 | 112.4 | 75.0 | 92.3 |
| Options | 714.8 | 608.4 | 737.4 | 797.5 | 822.3 | 881.4 |
| All Other | 685.2 | 703.6 | 728.9 | 1308.6 | 964.7 | 1205.0 |
| Gains/Losses from Trading Accounts | 3137.8 | 4237.5 | 5951.5 | 6839.0 | 7563.8 | 9944.3 |
| Mkt Making-OTC Equities | 664.4 | 607.3 | 655.7 | 1381.3 | 862.9 | 1229.8 |
| OTC Mkt Making-Listed Equities | 60.3 | 38.3 | 37.7 | 51.7 | 45.7 | 52.5 |
| Trading-Debt Securities | 1894.2 | 3081.3 | 4454.6 | 4418.1 | 5524.9 | 7206.5 |
| Mkt Making-Options | 1.9 | -1.0 | 11.1 | 63.6 | 31.1 | 159.1 |
| All Other Trading | 577.3 | 549.7 | 828.4 | 982.7 | 1147.7 | 1348.7 |
| Gains/Losses from Investment Accounts | 560.1 | 573.7 | 606.8 | 738.1 | 713.8 | 1089.2 |
| Realized Gains/Losses | 426.2 | 570.1 | 380.1 | 495.7 | 697.7 | 837.9 |
| Unrealized Gains/Losses | 104.0 | -23.7 | 159.9 | 166.2 | -10.4 | 187.3 |
| Profits/Losses from Underwriting | 1327.8 | 1568.1 | 2316.1 | 3541.4 | 2706.1 | 4250.3 |
| From Equities | 403.3 | 424.1 | 328.2 | 754.5 | 248.3 | 748.4 |
| Margin Interest | 2088.7 | 2890.1 | 2010.5 | 2129.5 | 2867.8 | 2577.7 |
| Revenue from Sale of Investment Company Shares | 104.7 | 122.0 | 287.5 | 952.1 | 750.9 | 1642.8 |
| Fees-Supervision, Advisory, Administrative | 175.4 | 274.8 | 356.1 | 569.5 | 693.8 | 947.4 |
| Revenue from Research Services | 14.3 | 15.8 | 8.3 | 18.7 | 11.1 | 17.8 |
| Commodities Revenue | 625.4 | 580.5 | 663.0 | 826.1 | 739.3 | 983.2 |
| Other Revenue-Securities-Related | 1727.6 | 2965.4 | 3942.3 | 4385.0 | 6282.8 | 7176.4 |
| Other Revenue | 586.1 | 1229.1 | 1055.9 | 1216.8 | 1792.1 | 1757.7 |
| Total Revenue | 16029.7 | 19796.1 | 23210.0 | 29566.4 | 31216.0 | 38622.2 |
| **EXPENSES** | | | | | | |
| RR Compensation | 3049.8 | 3334.2 | 4103.6 | 5750.2 | 5248.5 | 6903. |
| Clerical & Admin. Employee Expenses | 2548.1 | 3086.3 | 3702.8 | 4889.8 | 5147.5 | 6218.5 |
| Partners & Officers - Employment Expenses | 567.8 | 648.2 | 753.9 | 982.1 | 934.1 | 1119.9 |
| Other Employee Comp. * | 169.7 | 190.5 | 258.0 | 448.2 | 396.1 | 331.3 |
| Floor Expenses | 753.6 | 725.4 | 863.8 | 1142.9 | 1162.6 | 1310.3 |
| Brokerage Paid to Brokers | 263.2 | 265.3 | 316.7 | 390.1 | 399.1 | 441.9 |
| Commissions & Clearance | 283.0 | 246.6 | 275.7 | 390.4 | 395.3 | 459.5 |
| Clearance Paid to Non-brokers | 162.2 | 156.1 | 207.9 | 246.6 | 257.9 | 285.3 |
| Commissions Paid To Others * | 45.2 | 57.4 | 63.5 | 115.8 | 110.3 | 123.6 |
| Communications | 837.5 | 1103.3 | 1270.3 | 1538.4 | 1766.4 | 1921.8 |
| Occupancy & Equipment | 514.1 | 678.4 | 853.3 | 1138.4 | 1503.7 | 1830.7 |
| Promotional Costs | 347.2 | 456.9 | 530.2 | 735.1 | 769.2 | 841.5 |
| Interest Expense | 3444.8 | 5684.7 | 5480.7 | 6057.5 | 9505.4 | 10127.6 |
| Losses-Errors and Bad Debts | 204.5 | 153.6 | 193.3 | 233.0 | 212.0 | 266.3 |
| Data Processing Costs | 156.1 | 216.7 | 273.1 | 342.8 | 419.8 | 477.8 |
| Non-recurring Charges | 30.9 | 16.7 | 6.9 | 98.5 | 26.2 | 98.9 |
| Regulatory Fees and Expenses | 65.9 | 79.2 | 100.9 | 133.9 | 144.9 | 244.8 |
| Other Expenses | 1077.2 | 1280.7 | 1784.3 | 2251.3 | 2372.3 | 2797.4 |
| Total Expenses | 13767.4 | 17651.8 | 20175.4 | 25742.9 | 29608.2 | 34481.2 |
| Net Income | 2262.3 | 2144.3 | 3034.6 | 3823.5 | 1607.8 | 4140.0 |
| Net Income-After Tax | 1221.6 | 1157.9 | 1638.7 | 2064.7 | 868.2 | 2235.6 |

* From FOCUS Short Form, IIA

Out of the top 25 firms, it is the upper echelon group which keeps cutting the bigger revenue slice. The Top 10 capitalized firms have seen their share of industry revenues grow from just under half in 1979 to 58% last year. The Top 11-25 group has held steady at about 19% annually over the same years.

The inroads made by these Top 25 firms and the drop-off experienced by the "rest" are anything but evenly distributed.

The Top 25 firms are predominantly made up of National Full Line firms and Large Investment Banks.[1] Here we see that the two groups as a whole, which make up a mere 5% of the number of NYSE firms in this study, have increased their share of the group's revenues from a whopping 69% in 1980 to a staggering 75% last year. However, the LIBs made impressive inroads accounting for 31% of revenues last year vs 23% in 1980 while the NFLs' share of industry revenues fell from 46% back in 1980 to 43% last year.

Table 3

| | | | Firm Category's % Of Revenues | | | | | |
|---|---|---|---|---|---|---|---|---|
| Firm Category | Number Of Firms | % of All Firms | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 |
| National Full Line | 10 | 2 1/2 | 46 | 42 | 43 | 44 | 42 | 43 |
| Large Investment Banks | 10 | 2 1/2 | 23 | 29 | 30 | 28 | 32 | 31 |
| | 20 | 5 | 69 | 71 | 73 | 71 | 74 | 75 |
| Regionals | 104 | 26 | 14 | 14 | 12 | 12 | 10 | 10 |
| New York City Based | 52 | 13 | 8 | 8 | 6 | 6 | 5 | 5 |
| | 176 | 45 | 91 | 92 | 91 | 90 | 90 | 90 |
| Commission Introducing | 124 | 31 | 3 | 3 | 3 | 4 | 3 | 2 |
| | 300 | 76 | 95 | 94 | 94 | 93 | 93 | 93 |
| All Other | 94 | 24 | 5 | 6 | 6 | 7 | 7 | 7 |
| | 394 | 100 | 100 | 100 | 100 | 100 | 100 | 100 |

Source: Securities Industry Database
(from FOCUS Reports of 394 NYSE firms doing a public business)

Notes: Totals variations due to rounding; no firm is included in more than one category.

---

[1] The NFLs consist of six Top 10 firms and four Top 11-25 firms. The LIBs contain the remaining four top 10, four more 11-25 firms and two sub-25 firms.

Conversely, at the bottom of the pyramid the "other" securities firms, which include clearing firms, traders and market makers as well as "non-categorized" firms, have also been slicing a bigger piece of the revenue pie. They have improved their share of all revenues, going from 5% of all revenues in 1980 to 7% last year. Naturally if both the top and bottom of the pyramid are improving their share of revenue, the middle is losing. The main groups which are slicing smaller shares, besides the NFLs, are the Regionals, down from 14% of revenues in 1980 to 10% last year and the New York City Based firms, down to 5% in 1985 from 8% in 1980.

These groups show a similar pattern of in-roads and lost market share when it comes to the bottom line. The NFLs and LIBs together still enjoyed 65% of the industry's pre-tax profits in 1985, about their norm through the Eighties. But again, here the LIBs are gaining while the NFLs decline. Large Investment Banks have improved their share of profits dramatically, from 29% in 1980 to 43% last year. NFLs, conversely, fell from 35% of pre-tax income in 1980 to 23% last year (1984 was an aberration...in that off year, NFLs lost money while LIBs raked in 72% of the year's disappointing profits). And again at the bottom of the pyramid, the "other" securities firms have improved their 1980 9% share of pre-tax income to 15% last year.

Thus, as would be expected from their declining portion of revenues, the Regionals and the NYCs have also experienced declining share of industry profits. For the Regionals, it fell from 15% to 9% over the six-year period and from 9% to 6% for the NYCs.

Table 4

| | | | Firm Category's % Of Pre-Tax Net Income | | | | | |
|---|---|---|---|---|---|---|---|---|
| Firm Category | Number Of Firms | % of All Firms | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 |
| National Full Line | 10 | 2 1/2 | 35 | 27 | 29 | 29 | (7) | 23 |
| Large Investment Banks | 10 | 2 1/2 | 29 | 41 | 40 | 36 | 72 | 43 |
| | 20 | 5 | 64 | 68 | 68 | 65 | 65 | 65 |
| Regionals | 104 | 26 | 15 | 14 | 10 | 12 | 5 | 9 |
| New York City Based | 52 | 13 | 9 | 9 | 7 | 8 | 9 | 6 |
| | 176 | 45 | 88 | 90 | 85 | 85 | 79 | 81 |
| Commission Introducing | 124 | 31 | 4 | 3 | 4 | 5 | 5 | 4 |
| | 300 | 76 | 91 | 93 | 89 | 91 | 85 | 85 |
| All Other | 94 | 24 | 9 | 7 | 11 | 9 | 15 | 15 |
| | 394 | 100 | 100 | 100 | 100 | 100 | 100 | 100 |

Source: Securities Industry Database
(from FOCUS Reports of 394 NYSE firms doing a public business)

Notes: Totals variations due to rounding; no firm is included in more than one category.

## NATIONAL FULL LINE FIRMS

Having lost $118 million as a group in 1984, the only major firm category[2] to post in the red during this down period, or for all of the Eighties for that matter, 1985 was a more than welcome return to profitability. The $16.7 billion revenue showing last year was a record amount for the NFLs but comprised 43% of all industry revenues, a bit less than the 46% share this group enjoyed back in 1980.

On an itemized basis, the NFLs' line by line revenue performance closely mirrored that of the industry as a whole (as would be expected since this group makes up 43% of the industry's revenue totals). The NFLs' 1985 share of industry commissions was also 43%. But just four years earlier, NFLs accounted for over half of industry commissions. And just like the total industry as a group, the relative importance of commission dollars to the bottom line has been steadily declining. From 1980 to 1985, the contribution which commission revenues made to all revenues for the NFLs fell from 37% to 21%. For the industry the decline was almost identical, dropping from 35% in 1980 to 21% last year. And just like the industry as a whole, the NFLs' commissions last year fell short of the monies raised from this area in 1983. As reported in last month's TRENDS, the industry, and particularly the NFLs, find themselves in the position where they need more transactions to generate the same commission dollar.

In the area of trading gains, the increased importance to the bottom line is even more dramatic for the NFLs than the whole industry. While this area's share of total revenues increased from 20% to 26% for the industry from 1980 to 1985, it went from 16% to 27% for the NFLs. The same explosion in debt trading the industry latched onto as a revenue generator, the NFLs homed in also with a vengence. This area accounted for 78% of all NFLs' trading gains in 1985.

Underwriting revenues likewise exploded to over $2 billion for this group last year. That made up 13% of NFL revenues, way up from the 8% underwriting contributed back in 1980. But the industry's total underwriting revenues were also way up to a record $4.3 billion and the NFLs' share of it was just under half, not as good as earlier years when the NFLs accounted for over half of all industry underwriting revenues.

---

[2] The 16 Non-Carrying NYSE Discounters, as a sub-category of all Discounters, was the only other group to post an annual loss in the Eighties, a 1984 pre-tax loss of $1.8 million.

## Table 5

## STATEMENT OF INCOME
## NATIONAL FULL LINE FIRMS
(In $ millions)

| REVENUE | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 |
|---|---|---|---|---|---|---|
| Commissions | 2717.0 | 2407.2 | 2696.7 | 3528.7 | 2935.5 | 3523.6 |
| Listed Equities, On an Exchange | 1964.6 | 1739.3 | 1952.4 | 2856.1 | 2142.7 | 2636.4 |
| Listed Equities, OTC | 24.7 | 25.9 | 23.7 | 42.1 | 29.6 | 23.0 |
| Options | 459.6 | 390.0 | 465.9 | 487.2 | 478.1 | 519.4 |
| All Other | 258.1 | 252.0 | 244.8 | 443.9 | 285.0 | 344.8 |
| Gains/Losses from Trading Accounts | 1244.9 | 1445.9 | 2280.0 | 2891.8 | 3037.5 | 4505.8 |
| Mkt Making-OTC Equities | 362.3 | 324.9 | 369.8 | 779.7 | 525.2 | 722.1 |
| OTC Mkt Making-Listed Equities | 60.1 | 38.7 | 34.0 | 50.9 | 45.0 | 51.4 |
| Trading-Debt Securities | 675.3 | 1059.7 | 1853.0 | 1991.0 | 2337.5 | 3460.2 |
| Mkt Making-Options | 14.3 | 2.1 | 3.6 | 0.2 | 3.2 | 5.9 |
| All Other Trading | 192.3 | 45.3 | 52.9 | 121.1 | 170.3 | 317.4 |
| Gains/Losses from Investment Accounts | 72.5 | 92.6 | 7.6 | 36.5 | 109.8 | 92.4 |
| Realized Gains/Losses | 65.0 | 113.5 | 5.2 | 39.5 | 115.9 | 87.5 |
| Unrealized Gains/Losses | 7.5 | -20.9 | 2.4 | -3.0 | -5.2 | 3.9 |
| Profits/Losses from Underwriting | 634.3 | 720.6 | 1254.8 | 1592.9 | 1456.6 | 2074.7 |
| From Equities | 187.7 | 179.8 | 151.1 | 277.2 | 57.0 | 374.0 |
| Margin Interest | 1265.4 | 1698.1 | 1174.0 | 1200.5 | 1546.6 | 1357.1 |
| Revenue from Sale of Investment Company Shares | 61.4 | 74.3 | 208.1 | 777.3 | 549.6 | 1136.0 |
| Fees-Supervision, Advisory, Administrative | 56.0 | 91.3 | 133.0 | 249.6 | 285.1 | 397.2 |
| Revenue from Research Services | 0.0 | 5.2 | 0.6 | 2.1 | -1.2 | 0.0 |
| Commodities Revenue | 574.9 | 521.5 | 587.7 | 703.3 | 609.1 | 624.4 |
| Other Revenue-Securities-Related | 593.4 | 999.2 | 1169.9 | 1524.5 | 1979.0 | 2595.7 |
| Other Revenue | 105.8 | 269.5 | 375.6 | 315.0 | 559.5 | 365.5 |
| Total Revenue | 7326.1 | 8325.6 | 9888.9 | 12923.1 | 13066.3 | 16712.3 |
| **EXPENSES** | | | | | | |
| RR Compensation | 1856.3 | 1958.3 | 2452.0 | 3450.7 | 3245.5 | 4137.0 |
| Clerical & Admin. Employee Expenses | 1341.0 | 1022.0 | 1353.6 | 2627.1 | 2730.1 | 3398.1 |
| Partners & Officers - Employment Expenses | 89.5 | 109.4 | 134.1 | 177.1 | 190.5 | 204.2 |
| Other Employee Comp. * | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Floor Expenses | 281.1 | 250.5 | 308.2 | 361.5 | 346.9 | 374.3 |
| Brokerage Paid to Brokers | 110.9 | 110.5 | 123.2 | 141.7 | 131.3 | 140.6 |
| Commissions & Clearance | 72.9 | 55.4 | 63.6 | 82.9 | 75.3 | 81.3 |
| Clearance Paid to Non-brokers | 97.4 | 84.5 | 121.4 | 137.2 | 140.3 | 152.4 |
| Commissions Paid To Others * | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Communications | 406.0 | 544.0 | 767.3 | 923.0 | 1045.5 | 1157.1 |
| Occupancy & Equipment | 290.0 | 365.2 | 472.6 | 630.1 | 860.8 | 1067.0 |
| Promotional Costs | 201.0 | 265.6 | 324.7 | 468.0 | 456.9 | 500.4 |
| Interest Expense | 1218.3 | 1732.2 | 1460.3 | 1757.3 | 2822.2 | 3187.1 |
| Losses-Errors and Bad Debts | 159.7 | 103.3 | 133.9 | 152.9 | 144.5 | 180.2 |
| Data Processing Costs | 67.3 | 104.9 | 134.9 | 148.4 | 197.3 | 191.7 |
| Nonrecurring Charges | 20.1 | 3.5 | 5.0 | 94.5 | 10.3 | 35.6 |
| Regulatory Fees and Expenses | 28.0 | 32.7 | 39.6 | 46.3 | 49.2 | 123.9 |
| Other Expenses | 461.2 | 555.7 | 821.4 | 976.9 | 1042.7 | 1225.4 |
| Total Expenses | 6530.1 | 7748.3 | 9017.8 | 11813.8 | 13184.3 | 15772.8 |
| Net Income | 796.0 | 577.3 | 871.1 | 1109.3 | -118.0 | 939.5 |
| Net Income-After Tax | 429.3 | 311.7 | 470.4 | 599.9 | -63.7 | 537.3 |

* From FOCUS Short Form, IIA

All in all, the NFLs pretty much match industry trends but are slightly trailing industry revenue growth, now accounting for 43% of the toal vs 46% back in 1980.

On the flip side of the income statement, the NFLs employment costs still expend nearly half of all revenues coming in. Of that total, RR compensation still eats up a quarter of all dollars brought in and clerical and administrative employee expenses are still using up another one-fifth. The 10 NFLs are still accounting for 60% of all RR compensation paid by the 396 NYSE firms doing a public business.

Table 6

EMPLOYEES

| Firm Category | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 |
|---|---|---|---|---|---|---|
| National Full Line | 80,989 | 92,871 | 100,330 | 112,572 | 122,538 | 127,522 |
| Large Investment Banks | 15,774 | 17,841 | 19,923 | 23,948 | 25,124 | 26,957 |
| Regionals | N/A | 31,236 | 31,500 | 34,308 | 36,183 | 35,648 |
| New York City Based | N/A | 10,894 | 10,868 | 11,193 | 11,716 | 12,351 |
| NYSE Discounters | N/A | 611 | 1,214 | 1,618 | 2,080 | 2,683 |
| Total Securities Industry* | 139,825 | 160,628 | 170,966 | 191,970 | 207,477 | 214,621 |

* Includes other firms categories.

Total employment expenses of the NFLs last year accounted for 53% of industry employment expenses. That's not a bad ratio since the NFLs employ a higher 59% of the industry's people...127,522 NFL employees last year vs. 214,621 NYSE member firm employees. Interest ate up 19% of revenues last year, which was less than the 21% it took in the previous year but still higher than the 14% to 15% share interest took in a couple of previous years. The year-to-year percentage drop is partly explained by the corresponding drop in interest rates and the longer-term increase is explained by the explosion of liabilities on the balance sheet (See TRENDS, 4/9/86). The NFLs accounted for 31% of the industry's interest expense, exactly the share the NFLs' $116 billion of 1985 year-end liabilities made up of the total industry's balance sheet. NFLs' communications costs have held steady as a percent of revenues in the 7% to 8% range over the years. Meanwhile, occupancy and equipment expenses' bite on revenues has nearly doubled since 1980, from 4% to 7% last year.

As usual, the NFLs' expenses are the highest in the industry relative to revenues and thus their profit margins are the thinnest. Back in 1980 the NFLs had a 10.9% pre-tax margin. This has steadily deteriorated to a mere 5.6% margin last year (discounting 1984 when NFLs posted in the red). In every year NFLs' margins underperformed all firm categories and the industry's margins. However, since 1984, the NFLs have also been underperforming the low margins of the U.S. manufacturing industry and those years weren't even good ones for this group!

The positive note, however, is that in the fourth quarter of last year, as happened for the entire industry, the NFLs' margins improved and the gap between this group and the industry in general narrowed.

Table 7

PRE-TAX PROFIT MARGINS
(In %)

| Firm Category | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 |
|---|---|---|---|---|---|---|
| National Full Line | 10.9 | 6.9 | 8.8 | 8.6 | (0.9) | 5.6 |
| Large Investment Banks | 17.7 | 15.4 | 17.4 | 16.7 | 11.4 | 14.6 |
| Regionals | 14.7 | 11.2 | 11.1 | 12.6 | 2.6 | 9.4 |
| New York City Based | 14.8 | 12.6 | 14.0 | 18.3 | 8.9 | 12.3 |
| Commission Introducing | 16.9 | 10.9 | 15.9 | 18.8 | 9.5 | 19.8 |
| NYSE Discounters | 17.5 | 12.2 | 13.6 | 14.0 | 0.3 | 8.9 |
| All Other | 22.7 | 13.6 | 24.8 | 19.2 | 13.5 | 24.8 |
| **Total Securities Industry** | **14.1** | **10.8** | **13.1** | **12.9** | **5.2** | **10.7** |
| | | | | | | |
| U.S. Manufacturing Cos. | 7.7 | 7.4 | 5.3 | 6.3 | 7.1 | 5.9 |

One of the buzzwords of the Eighties has been "financial supermarket". It was widely predicted, particularly in the financial press, that the future belonged to one-stop shopping for financial services. While these financial giants have added a lot to their aggregate bottom line by the addition of Wall Street goliaths in their own right, the low margins NFLs suffer by trying to be all things to all people suggest financial supermarkets may end up with narrower margins than other firms but probably not as bad as the razor-thin margins which have historically plagued their namesakes in the food industry.

## LARGE INVESTMENT BANKS

There is one category of securities firms which are the envy of the industry. Not only are they the envy of the industry but seem to be pretty popular outside this group as well. Less than a year ago only one of these 10 investment banks could be directly owned by investors through the purchase of common stock. And this stock kept soaring to new highs. But over a few short months three more of these premiere securities firms gone public and another has given up its private partnership status to another financial parent as a sixth had done several years earlier. This leaves only four of this group still in partners' private hands.

Their popularity is not surprising. As seen earlier, these 10 firms, making up a mere 2 1/2% of the NYSE firms doing a public business, have increased their share of all the NYSE group's revenues to 31% last year, up from a still impressive 23% in 1980. Their share of pre-tax earnings last year was even more staggering...43%. And they weathered the storm better than other firms, In 1984's off-year, these 10 firms accounted for 72% of the 394 NYSE firms' (doing a public business) pre-tax profits.

Their profit margins, as seen earlier, consistently outperform the industry as a group, though they're not the highest of all categories (smaller groups, in terms of revenues, such as Commission Introducing, Traders and Market Makers and "others" have higher margins but obviously much less profits in aggregate). Likewise, their ROEs consistently outperform the industry, but again aren't the highest of all. This is partly due to their immense leverage and thus lower relative equity bases (this may be tempered somewhat in the present year due to some of these bank's initial public offerings and sell-outs to financial conglomerates). Their level of leverage last year was a staggering 42 times assets to equity. Not only was that 2 1/3 times the next largest leverage figure for a major group (the NFLs' 18X assets to equity) but it was up substantially from a 31X leverage ratio just two years earlier.

Table 8

LEVEL OF LEVERAGE
(Assets to Equity)

| Firm Category | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 |
|---|---|---|---|---|---|---|
| National Full Line | 15X | 14X | 13X | 15X | 18X | 18X |
| Large Investment Banks | 32 | 31 | 34 | 31 | 36 | 42 |
| Regionals | 9 | 11 | 9 | 8 | 9 | 9 |
| New York City Based | 29 | 19 | 13 | 13 | 15 | 14 |
| Commission Introducing | 4 | 4 | 4 | 5 | 3 | 2 |
| NYSE Discounters | 4 | 6 | 8 | 6 | 7 | 9 |
| Total Securities Industry | 19 | 18 | 19 | 18 | 22 | 24 |

## Table 9

## STATEMENT OF INCOME
## LARGE INVESTMENT BANKS
(In $ millions)

| | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 |
|---|---|---|---|---|---|---|
| **REVENUE** | | | | | | |
| Commissions | 651.7 | 661.6 | 802.6 | 1215.4 | 1068.1 | 1127.1 |
| Listed Equities, On an Exchange | 563.4 | 565.4 | 702.3 | 1044.5 | 915.0 | 967.2 |
| Listed Equities, OTC | 3.0 | 20.3 | 8.1 | 14.5 | 2.1 | 4.0 |
| Options | 48.1 | 37.6 | 57.3 | 57.8 | 70.4 | 74.1 |
| All Other | 37.3 | 37.3 | 34.9 | 92.0 | 80.7 | 81.1 |
| Gains/Losses from Trading Accounts | 1273.0 | 2042.1 | 2675.1 | 2708.2 | 3397.4 | 3874.2 |
| Mkt Making-OTC Equities | 91.3 | 70.4 | 86.5 | 243.7 | 116.5 | 163.3 |
| OTC Mkt Making-Listed Equities | 0.0 | 0.0 | 0.0 | 0.0 | 1.9 | 0.0 |
| Trading-Debt Securities | 1003.6 | 1672.5 | 2094.6 | 2013.4 | 2701.6 | 3020.6 |
| Mkt Making-Options | 5.5 | -10.7 | -9.1 | 41.9 | -2.7 | 102.5 |
| All Other Trading | 172.7 | 309.9 | 503.3 | 409.2 | 580.0 | 585.0 |
| Gains/Losses from Investment Accounts | 277.0 | 314.1 | 217.0 | 365.4 | 364.1 | 409.2 |
| Realized Gains/Losses | 217.5 | 334.6 | 195.7 | 281.5 | 342.5 | 471.9 |
| Unrealized Gains/Losses | 59.6 | -20.5 | 21.3 | 83.7 | 21.6 | -63.5 |
| Profits/Losses from Underwriting | 331.9 | 369.0 | 560.0 | 1050.6 | 733.9 | 1370.0 |
| From Equities | 120.9 | 119.8 | 97.3 | 230.1 | 97.5 | 223.2 |
| Margin Interest | 216.9 | 232.4 | 183.0 | 269.4 | 385.4 | 373.5 |
| Revenue from Sale of Investment Company Shares | 1.0 | 1.8 | 2.6 | 9.9 | 11.3 | 28.7 |
| Fees-Supervision, Advisory, Administrative | 15.2 | 51.3 | 57.3 | 84.6 | 111.4 | 171.6 |
| Revenue from Research Services | 0.5 | 0.4 | 0.6 | 0.4 | 0.4 | 0.5 |
| Commodities Revenue | 13.9 | 15.1 | 19.7 | 62.2 | 64.8 | 290.2 |
| Other Revenue-Securities-Related | 662.5 | 1327.5 | 2060.5 | 1980.4 | 3326.6 | 3483.8 |
| Other Revenue | 230.0 | 626.9 | 361.4 | 458.1 | 639.5 | 951.5 |
| Total Revenue | 3673.8 | 5585.9 | 6944.4 | 8209.2 | 10102.9 | 12097.5 |
| **EXPENSES** | | | | | | |
| RR Compensation | 333.3 | 441.0 | 604.0 | 956.7 | 786.1 | 1123.3 |
| Clerical & Admin. Employee Expenses | 464.0 | 575.2 | 794.4 | 1047.5 | 1139.6 | 1301.7 |
| Partners & Officers - Employment Expenses | 122.4 | 143.2 | 193.4 | 269.2 | 300.8 | 401.4 |
| Other Employee Comp. * | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Floor Expenses | 94.7 | 98.3 | 143.1 | 202.9 | 215.9 | 217.3 |
| Brokerage Paid to Brokers | 48.6 | 54.0 | 76.7 | 106.3 | 120.6 | 133.9 |
| Commissions & Clearance | 30.5 | 27.5 | 38.7 | 65.0 | 59.9 | 49.5 |
| Clearance Paid to Non-brokers | 15.6 | 16.8 | 27.7 | 31.6 | 35.4 | 33.9 |
| Commissions Paid To Others * | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Communications | 109.1 | 140.6 | 171.6 | 231.2 | 260.8 | 287.4 |
| Occupancy & Equipment | 76.9 | 100.5 | 133.7 | 205.8 | 258.7 | 317.0 |
| Promotional Costs | 55.4 | 66.6 | 79.3 | 109.8 | 139.7 | 179.4 |
| Interest Expense | 1509.6 | 2959.1 | 3157.0 | 3358.0 | 5319.2 | 5722.3 |
| Losses-Errors and Bad Debts | 11.9 | 13.5 | 21.6 | 28.9 | 20.9 | 24.0 |
| Data Processing Costs | 25.9 | 37.8 | 45.4 | 68.2 | 85.4 | 141.0 |
| Nonrecurring Charges | 0.1 | 0.5 | 0.0 | 0.0 | 0.2 | 7.0 |
| Regulatory Fees and Expenses | 5.2 | 7.8 | 10.1 | 22.5 | 27.8 | 34.4 |
| Other Expenses | 216.3 | 268.9 | 395.0 | 415.1 | 393.5 | 615.4 |
| Total Expenses | 3024.8 | 4774.7 | 5739.0 | 6835.9 | 8947.5 | 10332.0 |
| Net Income | 649.0 | 811.2 | 1205.4 | 1373.3 | 1155.4 | 1765.6 |
| Net Income-After Tax | 350.5 | 470.4 | 650.9 | 741.6 | 623.9 | 953.4 |

* From FOCUS Short Form, IIA

The increased leverage came from a doubling on the LIBs' balance sheet of liabilities over the past two years from $106 billion at 1983's close to $209 billion this past December. Going back to 1980, we find a five-fold increase in total liabilities to date. The growth in ownership equity over the same time frames lagged the debt increases. For the two-year span, ownership equity had a one-and-one-half-fold increase and since 1980 it experienced a four-fold increase to $5.2 billion on December 31, 1985. Again, the new infusions of capital from mergers and initial public offerings in 1986 may balance-out these increasing balance sheet rates.

As opposed to the NFLs' client base crossing the broad spectrum of the American public, the LIBs' targeted clientele and product lines creates a huge disparity in the level of employment and revenues per employee for these two groups.

As seen earlier, though the NFLs accounted for a greater 43% of industry revenues last year than the LIBs' 31%, the LIBs' targeted market approach allows them to function with far less, one-fifth, the number of employees than the NFLs employ. This allows the LIBs to reap in more than triple the amount of revenues per employee than the NFLs and two-and-one-half times the industry as a whole.

Table 10

$ REVENUE PER EMPLOYEE

| Firm Category | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 |
|---|---|---|---|---|---|---|
| National Full Line | 90,458 | 89,647 | 98,564 | 114,799 | 106,631 | 131,054 |
| Large Investment Banks | 232,905 | 316,464 | 348,562 | 342,793 | 402,115 | 448,771 |
| Regionals | N/A | 87,054 | 89,061 | 105,926 | 89,531 | 112,629 |
| New York City Based | N/A | 136,390 | 131,905 | 156,669 | 145,487 | 167,684 |
| NYSE Discounters | N/A | 189,096 | 176,248 | 213,809 | 171,313 | 180,680 |
| Total Securities Industry* | 114,641 | 123,242 | 135,758 | 154,016 | 150,455 | 179,951 |

* Includes other firm categories.

This industry-best performance is even more pronounced when looking at profit per employee since the LIBs targeted strategy allows them to capture the biggest share of industry profits, 43% last year. In 1985, the LIBs' perennially industry-best performance in pre-tax profit per employee jumped 42% from the previous year to a huge $65,497 profit per person. That's nine times the NFLs' level and more than triple the industry level.

## Table 11

# STATEMENT OF INCOME
# REGIONAL FIRMS
(In $ millions)

| REVENUE | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 |
|---|---|---|---|---|---|---|
| Commissions | 1059.1 | 966.1 | 1039.0 | 1013.6 | 1175.5 | 1352.5 |
| Listed Equities, On an Exchange | 711.8 | 646.2 | 680.9 | 481.4 | 728.9 | 831.6 |
| Listed Equities, OTC | 10.7 | 16.1 | 16.4 | 27.9 | 11.5 | 15.9 |
| Options | 106.2 | 69.9 | 102.7 | 114.5 | 129.0 | 128.7 |
| All Other | 230.4 | 234.1 | 239.2 | 389.9 | 306.1 | 376.0 |
| Gains/Losses from Trading Accounts | 330.5 | 401.1 | 497.3 | 596.2 | 530.4 | 712.3 |
| Mkt Making-OTC Equities | 144.0 | 150.6 | 147.0 | 254.5 | 173.7 | 229.9 |
| OTC Mkt Making-Listed Equities | 0.1 | -0.2 | 0.1 | 0.6 | 0.2 | 0.4 |
| Trading-Debt Securities | 134.0 | 199.5 | 285.5 | 260.7 | 296.3 | 399.1 |
| Mkt Making-Options | 0.3 | -2.0 | -3.3 | 4.0 | 0.6 | 1.2 |
| All Other Trading | 51.0 | 53.2 | 66.4 | 82.0 | 62.6 | 81.4 |
| Gains/Losses from Investment Accounts | 22.1 | 29.1 | 56.4 | 34.3 | 17.2 | 57.0 |
| Realized Gains/Losses | 12.6 | 23.0 | 56.8 | 25.3 | 23.1 | 38.0 |
| Unrealized Gains/Losses | 9.6 | 6.0 | -0.5 | 8.9 | -5.0 | 19.1 |
| Profits/Losses from Underwriting | 249.3 | 332.6 | 369.3 | 630.9 | 396.0 | 592.2 |
| From Equities | 42.2 | 108.2 | 62.5 | 195.6 | 73.6 | 106.9 |
| Margin Interest | 324.4 | 503.6 | 311.4 | 307.9 | 400.3 | 277.7 |
| Revenue from Sale of Investment Company Shares | 38.7 | 41.7 | 64.5 | 138.3 | 161.1 | 370.2 |
| Fees-Supervision,Advisory,Administrative | 24.5 | 29.8 | 36.4 | 46.2 | 43.7 | 58.8 |
| Revenue from Research Services | 3.0 | 1.4 | 3.8 | 10.7 | 6.3 | 11.0 |
| Commodities Revenue | 30.8 | 31.4 | 36.2 | 42.8 | 40.5 | 44.3 |
| Other Revenue-Securities-Related | 140.7 | 265.1 | 314.5 | 340.4 | 410.1 | 471.3 |
| Other Revenue | 50.9 | 97.4 | 76.0 | 72.6 | 58.4 | 68.3 |
| Total Revenue | 2293.9 | 2719.2 | 2805.4 | 3634.1 | 3239.5 | 4015.0 |
| **EXPENSES** | | | | | | |
| RR Compensation | 587.2 | 689.1 | 732.8 | 1035.8 | 846.7 | 1117.2 |
| Clerical & Admin. Employee Expenses | 370.1 | 429.8 | 471.8 | 610.1 | 604.5 | 711.4 |
| Partners & Officers - Employment Expenses | 193.0 | 191.0 | 213.1 | 258.1 | 221.2 | 273.9 |
| Other Employee Comp. * | 0.0 | 0.0 | 0.0 | 0.0 | 1.5 | 0.0 |
| Floor Expenses | 126.0 | 121.7 | 135.9 | 174.2 | 166.1 | 193.6 |
| Brokerage Paid to Brokers | 31.3 | 30.8 | 35.6 | 40.6 | 38.2 | 42.9 |
| Commissions & Clearance | 73.7 | 68.0 | 74.9 | 102.2 | 93.2 | 114.7 |
| Clearance Paid to Non-brokers | 21.0 | 21.7 | 25.4 | 31.4 | 34.7 | 36.0 |
| Commissions Paid To Others * | 0.0 | 1.2 | 0.0 | 0.0 | 0.0 | 0.0 |
| Communications | 140.7 | 201.5 | 200.9 | 237.1 | 261.6 | 269.2 |
| Occupancy & Equipment | 80.4 | 126.6 | 135.4 | 168.4 | 196.5 | 219.4 |
| Promotional Costs | 55.2 | 74.3 | 75.6 | 98.0 | 97.8 | 104.7 |
| Interest Expense | 237.1 | 424.4 | 310.3 | 297.5 | 424.0 | 366.5 |
| Losses-Errors and Bad Debts | 18.7 | 19.7 | 22.0 | 28.3 | 23.4 | 27.6 |
| Data Processing Costs | 30.4 | 34.1 | 38.6 | 51.0 | 55.5 | 64.4 |
| Nonrecurring Charges | 7.6 | 13.4 | 0.4 | 2.0 | 11.7 | 4.3 |
| Regulatory Fees and Expenses | 13.1 | 16.8 | 18.7 | 27.4 | 28.9 | 33.3 |
| Other Expenses | 96.3 | 116.2 | 139.4 | 187.9 | 215.4 | 249.5 |
| Total Expenses | 1956.4 | 2415.8 | 2494.5 | 3176.4 | 3155.4 | 3636.5 |
| Net Income | 337.5 | 303.4 | 310.9 | 457.7 | 84.1 | 378.5 |
| Net Income-After Tax | 192.3 | 163.9 | 167.9 | 247.2 | 45.4 | 204.4 |

* From FOCUS Short Form, IIA

## Table 12

### $ PRE-TAX PROFIT PER EMPLOYEE

| Firm Category | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 |
|---|---|---|---|---|---|---|
| National Full Line | 8,855 | 6,216 | 8,682 | 9,854 | (963) | 7,367 |
| Large Investment Banks | 41,144 | 48,831 | 60,903 | 57,345 | 45,988 | 65,497 |
| Regionals | N/A | 9,713 | 9,870 | 13,341 | 2,324 | 10,618 |
| New York City Based | N/A | 17,175 | 18,504 | 28,688 | 12,922 | 20,541 |
| NYSE Discounters | N/A | 23,077 | 23,970 | 29,852 | 529 | 16,027 |
| Total Securities Industry | 16,180 | 13,349 | 17,750 | 19,917 | 7,749 | 19,290 |

On the expense side of the income statement, the LIBs' lower labor roll and high leverage show their labor and interest expenses having an inverse relationship to the NFLs or the industry as a whole. While the industry's employment expense has averaged just under 40% of all revenues and the NFLs just under half of all revenues, the LIBs' employment costs have averaged less than a quarter of all revenues. On the interest expense side, while the industry's expenses ate up a quarter of all revenues on average through the Eighties and the NFLs, 17.5%, LIBs' interest expense has hovered between 41% and 52% through the Eighties, landing at 47% last year.

But as said, the leverage and targeting plan is working and translating into excellent bottom line performance. And, as was true with the industry as a group, the picture bodes well for 1986. Most revenues and profits were made during the fourth quarter of last year. From individual quarterly reports and FOCUS data already compiled, the first quarter of 1986 will show an even greater return rate than 1985's fine final quarterly showing.

## REGIONAL FIRMS

At first blush, Regional firms' 350% rebound in pre-tax profits last year would seem cause enough for celebration. But isolated number crunching often can obscure the big picture better than a San Francisco fog can veil the Golden Gate. Compared to 1983, the Regionals' best year ever, 1985's profitability performance was down 17% on a pre-tax basis. And retracing their performance a few more years back, to 1980, last year's profits were only 12% better. As if that wasn't bad enough, in real dollars (inflation adjusted to the Consumer Price Index) last year's pre-tax profits by the Regionals was down 29% from 1980.

## Table 13

### STATEMENT OF INCOME
### NEW YORK CITY BASED FIRMS
### (In $ millions)

| | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 |
|---|---|---|---|---|---|---|
| **REVENUE** | | | | | | |
| Commissions | 637.7 | 503.6 | 629.2 | 794.3 | 660.8 | 872.0 |
| Listed Equities, On an Exchange | 497.2 | 356.4 | 463.1 | 566.9 | 503.3 | 635.5 |
| Listed Equities, OTC | 3.5 | 5.0 | 3.5 | 12.0 | 14.2 | 27.2 |
| Options | 48.1 | 44.1 | 45.4 | 43.7 | 46.5 | 54.7 |
| All Other | 86.9 | 98.1 | 117.1 | 171.7 | 107.9 | 153.7 |
| Gains/Losses from Trading Accounts | 141.1 | 152.4 | 188.1 | 259.4 | 206.2 | 330.7 |
| Mkt Making-OTC Equities | 50.5 | 46.5 | 38.5 | 73.4 | 31.5 | 57.5 |
| OTC Mkt Making-Listed Equities | 0.0 | 0.0 | 0.0 | 0.3 | 0.0 | 0.4 |
| Trading-Debt Securities | 51.0 | 55.4 | 95.5 | 100.5 | 113.4 | 164.5 |
| Mkt Making-Options | 1.6 | 2.1 | 2.9 | 4.2 | 14.3 | 7.2 |
| All Other Trading | 38.0 | 48.5 | 51.3 | 73.5 | 41.9 | 111.5 |
| Gains/Losses from Investment Accounts | 56.8 | 66.2 | 108.4 | 73.0 | 62.7 | 74.1 |
| Realized Gains/Losses | 55.7 | 67.7 | 80.5 | 83.5 | 56.5 | 65.1 |
| Unrealized Gains/Losses | 1.0 | -1.5 | 27.9 | -10.5 | 6.0 | 7.0 |
| Profits/Losses from Underwriting | 65.0 | 81.4 | 72.7 | 86.9 | 35.4 | 62.4 |
| From Equities | 11.5 | 14.4 | 11.2 | 37.9 | 10.5 | 17.3 |
| Margin Interest | 182.6 | 274.8 | 163.9 | 174.5 | 230.0 | 206.3 |
| Revenue from Sale of Investment Company Shares | 2.4 | 3.0 | 7.6 | 11.4 | 8.6 | 29.1 |
| Fees-Supervision,Advisory,Administrative | 23.3 | 30.3 | 35.4 | 64.2 | 114.7 | 155.1 |
| Revenue from Research Services | 10.2 | 8.1 | 3.3 | 3.9 | 2.5 | 2.1 |
| Commodities Revenue | 5.9 | 6.6 | 10.4 | 12.5 | 17.4 | 10.4 |
| Other Revenue-Securities-Related | 220.5 | 241.2 | 190.4 | 221.7 | 240.6 | 275.7 |
| Other Revenue | 14.4 | 18.1 | 12.5 | 47.5 | 107.2 | 31.0 |
| Total Revenue | 1350.0 | 1465.6 | 1433.6 | 1753.6 | 1704.5 | 2071.0 |
| **EXPENSES** | | | | | | |
| RR Compensation | 221.4 | 220.6 | 235.0 | 306.7 | 264.4 | 364.8 |
| Clerical & Admin. Employee Expenses | 199.2 | 239.3 | 259.0 | 298.9 | 321.6 | 395.4 |
| Partners & Officers - Employment Expenses | 57.5 | 87.0 | 90.3 | 96.5 | 84.4 | 45.0 |
| Other Employee Comp. * | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 12.5 |
| Floor Expenses | 131.6 | 121.3 | 117.6 | 140.7 | 139.5 | 188.7 |
| Brokerage Paid to Brokers | 34.5 | 38.0 | 42.2 | 45.3 | 40.1 | 51.0 |
| Commissions & Clearance | 79.5 | 70.1 | 61.8 | 81.0 | 83.0 | 109.9 |
| Clearance Paid to Non-brokers | 12.8 | 13.2 | 13.6 | 14.4 | 16.4 | 18.8 |
| Commissions Paid To Others * | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 9.0 |
| Communications | 62.1 | 72.6 | 76.5 | 74.1 | 86.4 | 104.1 |
| Occupancy & Equipment | 43.6 | 49.2 | 61.0 | 65.1 | 85.1 | 107.3 |
| Promotional Costs | 25.2 | 31.2 | 30.4 | 29.0 | 34.7 | 45.1 |
| Interest Expense | 295.7 | 347.9 | 236.3 | 257.5 | 346.8 | 267.9 |
| Losses-Errors and Bad Debts | 7.8 | 3.6 | 7.7 | 6.9 | 9.4 | 10.3 |
| Data Processing Costs | 15.9 | 18.9 | 21.7 | 27.2 | 26.5 | 29.0 |
| Non-recurring Charges | 1.4 | 1.2 | 1.4 | 0.4 | 3.6 | 30.6 |
| Regulatory Fees and Expenses | 9.8 | 9.6 | 16.5 | 17.5 | 13.1 | 22.4 |
| Other Expenses | 76.5 | 90.3 | 79.5 | 111.9 | 137.2 | 145.6 |
| Total Expenses | 1152.4 | 1278.7 | 1232.5 | 1432.5 | 1553.5 | 1817.3 |
| Net Income | 200.6 | 187.1 | 201.1 | 321.1 | 151.0 | 253.7 |
| Net Income-After Tax | 108.3 | 101.0 | 105.6 | 173.4 | 81.5 | 137.0 |

* From FOCUS Short Form, IIA

This group's bread and butter revenue source, commissions, fell in line with the industry as a whole in terms of relative contribution to total revenues. For the Regionals, the 34% commissions contributed to total revenues last year was 12% less than they contributed (46%) back in 1980. The comparable drop for the industry was 14% over these six years. However, the Regionals trailed the industry in how higher trading gains helped offset the lost commissions. Underwriting revenues last year accounted for 15% of all revenues, the most (sans 1983's 17%) it comprised during the Eighties. A hefty 35% of underwriting revenues were made during last year's fourth quarter. On one hand this could bode well for the Regionals this year since corporate underwritings during 1986's first quarter were way up to record levels of $68 billion. On the other hand, however, municipal financings, one of the Regionals' strong suits, dramatically fell off to just $11 billion, a mere 5% of full year 1985's record amount.

Other measures of profitability also point to the albatrosses on the Regionals' horizon. Disregarding 1984, last year's 9.4% pre-tax profit margin was the lowest of the Eighties. Their pre-tax return on equity (their level of leverage has held steady at assets nine times equity) of 29% was also the lowest of the Eighties (again, sans 1984) and only one other major group, NYSE Discounters, came in with a lower figure, 26%.

Regionals' employment costs last year ate up 52.4% of all revenues. That was up from 51.7% in 1984 even though the Regionals were the only major firm category to reduce overall employment in 1985! Reductions in hiring helped the revenue per employee figure to rise to $112,629 in 1985 but the pre-tax profit per employee figure of $10,618 last year was well below the $13,341 showing back in 1983.

In sum, the Regionals as a group are losing ground within the industry. They account for 26% of all the NYSE firms doing a public business but last year garnered only 10% of this group's revenues, down from 14% back in 1980, and only 9% of pre-tax profits, down from 15% in 1980.

## NEW YORK CITY BASED

The New York City based Regionals have experienced the same problems as their counterparts in other cities. As a group, they make up 13% of NYSE firms doing a public business but have seen their share of this group's total revenues fall to 5% last year from 8% back in 1980. Likewise, their share of pre-tax profits is down to 6% in 1985 from 9% back in 1980. Their pre-tax margins (excluding 1984) hit their lowest level of the Eighties last year. The $254 million of pre-tax profits achieved last year was 21% less than 1983's $321 million and adjusted for real dollars (using the Consumer Price Index) last year's pre-tax profits were 14% less than six years earlier.

## Table 14

## STATEMENT OF INCOME
## COMMISSION INTRODUCING FIRMS
(In $ millions)

| | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 |
|---|---|---|---|---|---|---|
| REVENUE | | | | | | |
| Commissions | 281.9 | 280.0 | 335.8 | 500.0 | 430.3 | 417.7 |
| Listed Equities, On an Exchange | 228.0 | 225.8 | 277.5 | 379.6 | 332.4 | 333.4 |
| Listed Equities, OTC | 0.0 | 0.0 | 0.2 | 0.0 | 0.0 | 0.1 |
| Options | 16.4 | 14.9 | 18.6 | 21.7 | 20.5 | 20.3 |
| All Other | 37.6 | 39.4 | 39.5 | 98.6 | 77.3 | 63.9 |
| Gains/Losses from Trading Accounts | 65.0 | 51.0 | 104.9 | 146.6 | 154.2 | 171.5 |
| Mkt Making-OTC Equities | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 4.6 |
| OTC Mkt Making-Listed Equities | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Trading-Debt Securities | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Mkt Making-Options | 0.5 | 0.8 | 4.5 | 1.2 | -1.0 | 0.6 |
| All Other Trading | 64.5 | 49.9 | 100.4 | 145.5 | 155.3 | 166.4 |
| Gains/Losses from Investment Accounts | 23.1 | 22.1 | 47.4 | 64.5 | 27.7 | 48.7 |
| Realized Gains/Losses | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Unrealized Gains/Losses | 0.0 | 0.0 | 0.0 | 0.0 | -0.4 | 0.0 |
| Profits/Losses from Underwriting | 29.8 | 42.1 | 33.5 | 159.4 | 48.2 | 68.1 |
| From Equities | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Margin Interest | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | -0.7 |
| Revenue from Sale of Investment Company Shares | 1.0 | 1.2 | 4.6 | 14.3 | 17.6 | 24.3 |
| Fees-Supervision,Advisory,Administrative | 23.2 | 30.9 | 37.4 | 55.5 | 53.1 | 60.5 |
| Revenue from Research Services | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Commodities Revenue | -1.3 | 0.1 | 5.7 | 2.7 | 2.4 | 7.7 |
| Other Revenue-Securities-Related | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Other Revenue | 77.8 | 79.3 | 105.7 | 153.4 | 172.9 | 105.6 |
| Total Revenue | 500.9 | 506.5 | 676.1 | 1096.6 | 916.5 | 902.2 |
| EXPENSES | | | | | | |
| RR Compensation | 0.0 | 0.0 | 0.0 | 0.0 | 0.3 | 0.0 |
| Clerical & Admin. Employee Expenses | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Partners & Officers - Employment Expenses | 50.0 | 63.7 | 72.4 | 91.4 | 76.4 | 83.4 |
| Other Employee Comp. * | 169.1 | 175.4 | 229.3 | 390.2 | 333.5 | 271.3 |
| Floor Expenses | 33.9 | 36.2 | 39.8 | 57.6 | 55.5 | 62.9 |
| Brokerage Paid to Brokers | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Commissions & Clearance | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.1 |
| Clearance Paid to Non-Brokers | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Commissions Paid To Others * | 33.9 | 36.2 | 39.8 | 57.6 | 55.5 | 62.9 |
| Communications | 0.0 | 0.0 | 0.0 | 0.0 | 0.2 | 0.0 |
| Occupancy & Equipment | 0.0 | 0.0 | 0.0 | 0.0 | 0.5 | 0.0 |
| Promotional Costs | 0.0 | 0.0 | 0.0 | 0.0 | 0.2 | 0.0 |
| Interest Expense | 32.4 | 30.4 | 19.2 | 31.8 | 53.1 | 22.6 |
| Losses-Errors and Bad Debts | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Data Processing Costs | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Non-recurring Charges | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Regulatory Fees and Expenses | 4.3 | 4.3 | 5.0 | 6.6 | 9.2 | 10.7 |
| Other Expenses | 125.9 | 141.2 | 202.6 | 312.8 | 300.0 | 272.1 |
| Total Expenses | 415.4 | 451.1 | 568.5 | 890.4 | 829.6 | 723.3 |
| Net Income | 44.5 | 55.4 | 107.6 | 206.2 | 86.9 | 178.9 |
| Net Income-After Tax | 45.6 | 24.9 | 58.1 | 111.3 | 46.9 | 96.6 |

* From FOCUS Short Form, IIA

This group didn't experience as big an erosion of commission dollars' relative importance to all revenues as the industry and other groups did. Over the Eighties, NYCs' commissions as a percent of revenues fluctuated between 40% and 47%, settling at 42% last year. Trading gains importance to all revenues for NYCs followed the industry's increase, going from 10% of all revenues in 1980 to 16% last year. Underwriting profits, however, were the lowest of the Eighties (forgetting 1984's off-year again), and this in a record underwriting period.

One of the only saving points was that the final quarter of 1985 accounted for 40% of the NYCs' pre-tax profits. Hopefully this is being carried over into this year and results will improve this go-round.

## COMMISSION INTRODUCING FIRMS

Though the Commission Introducing firms make up 31% of the NYSE firms doing a public business, last year they garnered only 4% of this group's pre-tax income. Even though this group's pre-tax profits doubled last year and even though its expenses have declined for two straight years, its revenues have fallen from $1.1 billion in 1983 to $902 million last year so that it pre-tax profits have fallen 13% over the two years. And though in aggregate, particularly revenues, the CIs have been losing ground, their new found control of expenses has been improving the margins they are showing on what revenues they do bring in. For instance, its pre-tax profit margin of 19.8% was its best showing in the Eighties and the highest showing of any firm category (excluding the "other firms" catch-all group). Their 1985 44.5% pre-tax return on equity was the best of any firm category and one-and-one-half times the industry average although in other years, like 1983's 53.2% ROE, it has been higher.

Table 15

PRE-TAX RETURN ON EQUITY

| Firm Category | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 |
|---|---|---|---|---|---|---|
| National Full Line | 45.0 | 24.6 | 29.8 | 28.1 | (2.6) | 17.9 |
| Large Investment Banks | 55.7 | 56.7 | 54.8 | 43.8 | 31.1 | 38.5 |
| Regionals | N/A | 37.2 | 36.0 | 40.5 | 6.8 | 29.0 |
| New York City Based | N/A | 42.1 | 43.3 | 50.7 | 19.9 | 31.2 |
| Commission Introducing | N/A | 28.3 | 46.9 | 53.2 | 19.4 | 44.5 |
| NYSE Discounters | N/A | 52.2 | 53.9 | 46.7 | 0.8 | 25.6 |
| **Total Securities Industry** | **49.2** | **35.9** | **40.5** | **36.6** | **13.3** | **29.4** |
| U.S. Manufacturing Cos. | 21.9 | 21.4 | 14.1 | 16.3 | 19.2 | 15.7 |

## Table 16

## STATEMENT OF INCOME
## NYSE DISCOUNTERS
(In $ millions)

| | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 |
|---|---|---|---|---|---|---|
| **REVENUE** | | | | | | |
| Commissions | 48.1 | 78.7 | 146.4 | 258.1 | 232.3 | 294.6 |
| Listed Equities, On an Exchange | 40.6 | 61.4 | 113.9 | 185.6 | 155.5 | 184.2 |
| Listed Equities, OTC | 0.0 | 3.5 | 3.3 | 0.2 | 0.8 | 0.3 |
| Options | 3.6 | 8.4 | 19.4 | 30.0 | 29.4 | 35.2 |
| All Other | 3.9 | 5.4 | 9.5 | 42.2 | 46.6 | 74.4 |
| Gains/Losses from Trading Accounts | 0.0 | 0.3 | 1.8 | 5.0 | 4.8 | 8.7 |
| Mkt Making-OTC Equities | 0.0 | 0.0 | 0.1 | 0.4 | 0.9 | 0.7 |
| OTC Mkt Making-Listed Equities | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Trading-Debt Securities | 0.0 | 0.0 | 0.7 | 1.5 | 1.2 | 1.8 |
| Mkt Making-Options | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| All Other Trading | 0.0 | 0.3 | 1.1 | 2.7 | 3.0 | 6.2 |
| Gains/Losses from Investment Accounts | 0.0 | 0.0 | 5.2 | 1.7 | 0.5 | 2.3 |
| Realized Gains/Losses | 0.0 | 0.0 | 1.0 | 0.1 | 0.0 | 0.0 |
| Unrealized Gains/Losses | 0.0 | 0.1 | 3.5 | 0.2 | 0.1 | 0.2 |
| Profits/Losses from Underwriting | 0.0 | 0.2 | 1.6 | 1.7 | 1.6 | 0.9 |
| From Equities | 0.0 | 0.0 | 0.1 | 0.3 | 0.0 | 0.0 |
| Margin Interest | 1.8 | 17.7 | 30.5 | 43.1 | 72.6 | 87.4 |
| Revenue from Sale of Investment Company Shares | 0.0 | 0.0 | 0.0 | 0.5 | 1.9 | 3.2 |
| Fees-Supervision, Advisory, Administrative | 0.1 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Revenue from Research Services | 0.5 | 0.0 | 0.0 | 0.6 | 0.7 | 0.0 |
| Commodities Revenue | 0.1 | 0.1 | 0.3 | 0.3 | 0.5 | 0.4 |
| Other Revenue-Securities-Related | 1.7 | 8.0 | 9.0 | 14.2 | 22.2 | 53.3 |
| Other Revenue | 3.6 | 13.4 | 12.5 | 16.7 | 18.7 | 29.0 |
| Total Revenue | 61.3 | 115.5 | 213.9 | 345.9 | 356.4 | 483.8 |
| **EXPENSES** | | | | | | |
| RR Compensation | 2.3 | 6.6 | 14.9 | 19.7 | 21.9 | 23.2 |
| Clerical & Admin. Employee Expenses | 1.9 | 12.0 | 23.0 | 35.3 | 38.8 | 62.2 |
| Partners & Officers - Employment Expenses | 3.1 | 4.4 | 6.3 | 9.2 | 7.3 | 10.0 |
| Other Employee Comp. * | 7.6 | 7.3 | 9.0 | 25.5 | 26.5 | 28.7 |
| Floor Expenses | 12.7 | 19.3 | 27.7 | 48.5 | 50.0 | 56.5 |
| Brokerage Paid to Brokers | 1.1 | 1.5 | 3.7 | 7.3 | 5.5 | 8.5 |
| Commissions & Clearance | 1.4 | 5.5 | 11.0 | 6.2 | 7.0 | 12.1 |
| Clearance Paid to Non-brokers | 0.6 | 0.9 | 2.1 | 4.4 | 5.0 | 4.8 |
| Commissions Paid To Others * | 9.6 | 11.4 | 10.9 | 30.6 | 32.5 | 31.2 |
| Communications | 1.2 | 9.3 | 16.3 | 23.7 | 30.1 | 34.6 |
| Occupancy & Equipment | 0.4 | 4.5 | 10.3 | 13.1 | 25.7 | 33.3 |
| Promotional Costs | 0.9 | 4.3 | 7.4 | 11.4 | 13.5 | 14.8 |
| Interest Expense | 1.5 | 9.2 | 25.2 | 34.8 | 55.8 | 75.0 |
| Losses-Errors and Bad Debts | 0.1 | 0.7 | 2.2 | 3.1 | 2.1 | 2.4 |
| Data Processing Costs | 0.6 | 2.5 | 7.7 | 9.8 | 10.9 | 17.6 |
| Nonrecurring Charges | 0.0 | 0.0 | 0.1 | 0.1 | 0.0 | 0.0 |
| Regulatory Fees and Expenses | 0.5 | 0.3 | 1.1 | 2.4 | 2.1 | 3.0 |
| Other Expenses | 18.0 | 20.0 | 33.1 | 62.2 | 67.6 | 76.0 |
| Total Expenses | 50.6 | 101.4 | 184.8 | 297.5 | 355.3 | 441.4 |
| Net Income | 10.7 | 14.1 | 29.1 | 48.5 | 1.1 | 43.0 |
| Net Income-After Tax | 5.8 | 7.6 | 15.7 | 25.1 | 0.6 | 23.2 |

* From FOCUS Short Form, IIA

This drop-off is partly due to this group's "unleveraging" over the past few years. Their assets to equity ratio has dropped from five times in 1983 to just two times last year. Even though their equity has fallen from $485 million in 1983 to $425 million last year (it dipped further in 1984 to $391 million), the liabilities side of the balance sheet has experienced much more dramatic drop-offs.

The $524 million of liabilities at 1985's close was the lowest of the Eighties and less than one-third of the $1.8 billion of liabilities at 1983's close. Some liabilities fell drastically such as payables to dealers, brokers and clearance houses, down to $58 million last year from $725 million at 1983's close.

## NYSE DISCOUNTERS

Based on the 27 NYSE member Discounters doing a public business, which account for the largest Discounter firms and a majority of Discounter revenues, 1985 was their second best year ever. Pre-tax profits rose from $1.1 million in off-year 1984 to $43 million last year, but that was still below 1983's $48.3 million performance. Revenues, however, were at record levels, $485 million last year, a 40% increase over two years. Expenses, however, increased 48% over the same two years to $442 million in 1985. The biggest expense item was interest expense and over the two years 1983 to 1985, this increased 116% to $75 million. That's over 15% of the Discounters' 1985 revenues...two years earlier it was only 10%.

But this was mainly due to the balance sheet exploding for this group during the same period with assets more than doubling to $1.8 billion, mostly from increased liabilities which stood at $1.6 billion at 1985 year-end.

Commission income for this group, as for the industry, has become a smaller contributor to total revenues. In 1980 its contribution stood at 79%. Last year it stood at only 62%. This is still, by fact as well as definition, the Discounters main income source but as little as two years ago (1983) commissions were accounting for 75% of all revenues.

That isn't to say that aggregate commission dollars were down, from 1983 to 1985 they increased from $258 million to almost $300 million. But that's just 16% over two years. Meanwhile, the Discounter's bread and butter revenue source, retail sales, have been exploding. According to SIA's Investor Activity Report, the most sophisticated and new measure of retail activity which takes member trading statistics (which are mandated to be reported to the various exchanges) and institutional trades by the largest institutions out of the total share activity, and is not just an arbitrary retail proxy, retail activity has been blossomming.

Though the data is available only from May 1985 forward, the Report shows from May through year-end last year, public activity on the Big Board alone (excludes member trading) mushroomed 42%. Meanwhile, while public activity skyrocketed, the retail share of this volume increased from 38% to 40% by December. The latest figures show public activity increasing even further and as of March the retail portion of this increase climbed even higher to 44%. Similar patterns held true for the AMEX and OTC markets.

Therefore the commission revenue of Discounters, though up, is not up as much as one would think. The one favorable sign for the Discounters is that while commission revenues hovered around $70 million per quarter in 1985's first three quarters, Q4's showing jumped to $85 million.

Data for NASD Discounters was unavailable for this issue of TRENDS but will be included in the next issue dealing with firm category profitability.

## OTHER FIRMS

This residual category of securities firms covers nine Traders & Market Makers, a dozen Clearing firms and 46 non-classified houses.

As a group, they make up 24% of the NYSE firms doing a public business and as a group have been making inroads similar to the Large Investment Banks, albeit on a much smaller scale. In 1980 these firms accounted for just 5% of the total group's revenues and 9% of their pre-tax income. By last year this share had increased to 7% of revenues and a hefty 15% of pre-tax profits. And their profit margin of 24.8% last year matched their best showing of the Eighties, 24.8% in 1982. That figure was also the highest of any firm category during any of the past six years!

Of this group, the nine Traders & Market Makers had the most stellar improvement last year. From 1980 to 1984, the TMM's averaged a pre-tax income of $55 million (the lowest being $20 million in 1981 and the highest being $82 million in 1982). Last year, however, profits inflated faster than a balloon mortgage. The $228 million turned in was more than four times their 1980-84 average. The big gains came from debt trading and investment accounts.

The Clearing firms made a comeback from disastrous 1984, but last year's $13.5 million pre-tax profits was about the same as the $13.2 million earned in 1980, and that's before adjustment for inflation.

The unclassified firms had their best year in 1985. Pre-tax 1985 profits hit $339 million. That was 53% better than their previous high showing of $222 million in 1983.

## CONCLUSION

The securities industry has just come off its new record year and while all firm categories benefited from the up markets, some, particularly Large Investment Banks, benefited much more than others. Margins and other measures of profitability made sharp rebounds (they almost had to) from 1984 but most firm categories have seen better years when relative measurements and price deflators are studied. The fourth quarter, while the bull was in full force, was the predominant money maker for all firm categories. Therefore, with the same bull market forces in play thus far in 1986, securities firms should be addressing the weak and strong points for their category to take advantage of what can possibly be another record breaking year. And as noted in this month's TRENDS Flash, preliminary data shows that the first quarter already matched half of all last year's pre-tax securities industry record net.

George R. Monahan
Assistant Director of Research

VOLUME

| | MARCH 1986 | JAN - MAR 1986 | MARCH 1985 | JAN - MAR 1986 | % CHAN. J-M 1986-1985 |
|---|---|---|---|---|---|
| AVERAGE DAILY SHARE VOLUME ON | | | | | |
| NYSE (MILS.)* | 160.8 | 148.1 | 102.6 | 113.2 | 30.8% |
| AMEX (MILS.)* | 15.9 | 13.7 | 8.7 | 9.4 | 45.9% |
| NASDAQ (MILS.)* | 129.8 | 120.4 | 76.8 | 84.0 | 43.3% |
| REGIONAL EXCHANGE (MILS.)* | 27.7 | 25.2 | 20.2 | 19.8 | 26.9% |
| DOLLAR VALUE OF SHARES TRADED ON | | | | | |
| NYSE (MILS.) | $123.896 | $337.321 | $76.916 | $242.187 | 39.3% |
| AMEX (MILS.) | 1.687 | 7.399 | 2.465 | 7.025 | 5.3% |
| ODD-LOT SHARES PURCHASED ON NYSE (THOUS.) | 10.348 | 26.867 | 6.618 | 20.375 | 31.9% |
| ODD-LOT SHARES SOLD (INCLUDING SHORT SALES) ON NYSE (THOUS.) | 21.782 | 59.516 | 16.404 | 49.510 | 20.2% |
| NYSE BLOCK VOLUME AS A PERCENT OF TOTAL SHARES TRADED | 49.0% | 49.4% | 50.9% | 51.0% | ---- |
| CONTRACTS TRADED (THOUS.) | | | | | |
| CBOE OPTIONS | 16.395 | 47.472 | 12.060 | 37.236 | 27.5% |
| AMEX OPTIONS | 4.378 | 14.856 | 2.914 | 9.131 | 62.7% |
| COMMODITY | 15.140 | 47.183 | 13.602 | 39.667 | 18.9% |

*MONTHLY AVERAGE
N/A - DATA NOT AVAILABLE

## YIELDS

(MONTHLY AVERAGES)

| | MARCH 1986 | MARCH 1985 | BASIS POINT CHG 1986-1985 |
|---|---|---|---|
| BOND BUYER INDEX (20 BOND) | 7.20% | 9.77% | (257) |
| CORPORATE BOND YIELDS (MOODY'S) | | | |
| Aaa CORPORATE | 9.00 | 12.56 | (356) |
| Baa CORPORATE | 10.50 | 13.69 | (319) |
| RATIO Aaa CORPS. TO Baa CORPS. | 0.86 | 0.92 | (6) |
| MUNICIPAL BOND YIELDS (MOODY'S) | 7.08 | 9.77 | (269) |

## PRICES

(END OF MONTH)

| | APRIL 1986 | APRIL 1986 | % CHAN. Y-T-D 1986-1985 |
|---|---|---|---|
| DOW JONES INDUSTRIALS | 1783.98 | 1258.06 | 41.80% |
| STANDARD & POOR'S 500 | 235.52 | 179.83 | 30.97% |
| NYSE COMPOSITE | 135.75 | 104.12 | 30.38% |
| AMEX MARKET VALUE INDEX | 268.97 | 227.44 | 18.26% |
| VALUE LINE COMPOSITE | 238.6 | 191.58 | 24.54% |
| NASDAQ COMPOSITE | 383.24 | 280.56 | 36.60% |

## UNDERWRITING

| | APRIL 1986 | APRIL 1985 | % Change 1986-1985 |
|---|---|---|---|
| CORPORATE FINANCING (Gross New Issues - $ Mils) | | | |
| TOTAL | $33,221.5 | $11,147.3 | 198.0% |
| Common Stock | $5,041.8 | $2,094.9 | 140.7% |
| # of Common Stock Issues | 112 | 63 | 77.8% |
| Preferred Stock | $871.0 | $643.3 | 35.4% |
| # of Preferred Stock Issues | 14 | 12 | 16.7% |
| Corporate Debt | $37,308.7 | $8,409.1 | 343.7% |
| # of Corporate Debt Issues | 194 | 89 | 118.0% |
| MUNICIPAL FINANCING (Gross New Issues - $ Mils) | | | |
| Notes | $3,776.8 | $4,684.6 | -19.4% |
| Bonds | $11,144.7 | $10,732.7 | 3.8% |

Source: IDD Information Services and Bond Buyer

## MARGIN DEBT

| | MARCH 1986 | MARCH 1986 | % CHANGE 1986-1985 |
|---|---|---|---|
| MARGIN DEBT OUTSTANDING ($MILS) | 30.760 | 23.900 | 28.7% |
| NET CHANGE IN MARGIN DEBT ($MILS) | 6.860 | 1.071 | 540.5% |
| % OF ACCOUNTS WITH EQUITY UNDER 40% | 10% | 11% | ----- |

## RECENT INTERESTING READING AND STATISTICAL MATERIAL

| Item | Description | Source |
|---|---|---|
| Report on Production of RRs in 1985 & Earnings | SIA's thirteenth annual survey on RR production and earnings levels and trends, including data on payout percentages and ticket size. Information on the newly registered retail RR is an added feature providing information on production earnings and and training costs. Report is based on input from | SIA<br>Surveys Department<br>$400 1st copy, $50 additional copies for SIA member firms;<br>$1,200 1st copy, $50 additional copies for all others |
| "Summary of Senate Tax Reform Provisions" | A convenient and official summary listing of the principal tax reform proposals in the Senate Finance Committee bill. (Legislative documentation and Committee report not yet available.) | Bureau of National Affairs<br>5/13/86 |
| Investment Banking and Diligence What Price Deregulation? | Harvard Professors Auerbach and Hayes explore Rule 415 and its implications for due diligence. Starting with a perspective on the evolution of the securities industry since 1920, the authors detail competitive conditions at the time of passage of the Securities Act of 1933 and procedures which followed from it. These procedures are reviewed in the context of today's competitive pressures. What has occurred since the existence of Rule 415 is analyzed, including shifts in underwriting status of investment banks. Conclusion: Regulatory changes along the lines of Rule 415 were probably inevitable, but the SEC's deregulation procedure needs to be reconsidered. | 1986 Harvard Business School Press<br>Boston, Massachusetts |
| "Do Institutions Still Get the First Call?" | Author Charles Ellis gives a behind the scenes assessment of how the rules are changing in the institutional equity business, along with attitudes toward investment research. Q & A section, supported by data tables, on commission allocation and broker research. | Investment Decisions<br>May 1986 |

| | | |
|---|---|---|
| "Charles Schwab vs. Les Quick: Discount Brokering's Main Event" | Article describes the unique personalities and very different operating strategies of these two discounters. Radically different styles have lead to radically different growth paths for the respective companies: Schwab's revenue growth has been dramatic, while Quick's profitability has been remarkable. | Business Week<br>5/12/86 |
| NASD 1985 Fact Book | Comprehensive statistical fact book, including much historical data. 1985 was a record-setting year for the NASDAQ market, with share volume hitting 20.7 billion and single-day record volume reaching 141.5 million shares. The dollar volume of shares traded amounted to $233.5 billion, up 50% from 1985. | NASD<br>1735 K Street, N.W.<br>Washington, DC 20006 |
| Annual Report of the Federal Reserve Bank of New York | 1985 Report departs from tradition and presents a broad essay on the major features of financial change at work now. The forces focused on are innovation, competition, deregulation, securitization, and the associated growth of trading of financial instruments. Challenge ahead: understanding of new markets and techniques and their affect on the whole financial system. | Federal Reserve Bank of New York<br>Public Information<br>33 Liberty Street<br>New York, NY 10045 |
| "The Fortune 500" | Thirty-second annual listing of the 500 largest U.S. industrial companies. GM toppled Exxon as king of the hill in 1985. Special report runs 58-pages and includes the 500 by industry and ranked by 14 measures, the biggest turnaround, and the biggest money loser. | Fortune<br>4/28/86 |

Securities Industry
Trends
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Produced by the SIA Research Department

ANNUAL SUBSCRIPTION
$48.00 member • $72.00 non-member

A8825-1

VOL. XII, No. 6 June 6, 1986

## SIA TRENDS FLASH...1986'S STELLAR START CONFIRMED

This past May Day, SIA projected that this year's first quarter would see the securities industry post a record $2 billion in pre-tax profits. All the data is now in and the results are...a new record $2 billion in pre-tax profits, $1.945 billion to be more precise. The projection was based on results of the top 15 New York Stock Exchange firms doing a public business in this year's first quarter and their 1985 full year and Q4 performance, measured against their share of 1985's full year and Q4 performance for all NYSE firms doing a public business. The May TRENDS' Flash also projected 1986 Q1 industry revenues of about $13 billion. The final results...$13 billion, or $12.895 when carrying the decimal out a few notches. Likewise, projected expenses were $11 billion. Actual results...$11 billion ($10.950 billion for precision).

For the industry as a group, the new record quarter holds some promising statistics. This time, while the industry was posting record revenues it was able to keep expenses from outpacing the gains. Revenues increased a hefty 11% from 1985's fine final quarter. Expenses increased but much less so...only 8%. That left a lot of room for improvement on the bottom line. And improve it did. This year's first quarter showed a 32% increase in pre-tax net income over Q4 1985's then second best ever showing and was 20% better than the previous record quarter, 1982 Q4.

## REVENUE RAISERS

The two biggest revenue contributors in the securities industry, trading gains and commissions, improved dramatically this past quarter. Trading gains (from principal transactions/market making) shot up 31% to $4 billion. Commissions rose 23% to $2.8 billion. Trading gains' relative importance to total revenues continued its growing dominance. This past quarter it accounted for 31% of all revenues, much more than full year 1985's 26% and maintained its steady increase (it was less than 20% back in 1980). Commissions relative importance had dropped steadily from 35% of all revenues in 1980 to 21% last year. The first quarter did not, however, show any further erosion with commissions maintaining its 21% foothold.

## STATEMENT OF INCOME
## TOTAL SECURITIES INDUSTRY*
(In $ millions)

| | Q4 1985 | Q1 1986 | % Increase |
|---|---|---|---|
| **REVENUES** | | | |
| Commissions | $ 2,251 | $ 2,761 | 23 |
| Gains/Losses from Trading Accounts | 3,033 | 3,969 | 31 |
| Gains/Losses from Investment Accounts | 427 | 599 | 40 |
| Profits/Losses from Underwriting | 1,531 | 1,141 | (25) |
| Margin Interest | 708 | 700 | (1) |
| Sales of Investment Company Shares | 386 | 634 | 64 |
| Fees-Supervision, Advisory, Administrative | 294 | 272 | (7) |
| Revenue from Research Services | 3 | 5 | 67 |
| Commodities Revenue | 152 | 164 | 8 |
| Other Revenue - Securities - Related | 2,280 | 2,152 | (6) |
| Other Revenue | 532 | 498 | (6) |
| Total Revenue | $11,597 | $12,895 | 11 |
| **EXPENSES** | | | |
| RR Compensation | $ 1,911 | $ 2,233 | 17 |
| Clerical & Admin. Employee Expenses | 1,815 | 2,047 | 13 |
| Partners & Officers - Employment Expenses | 298 | 357 | 20 |
| Other Employee Comp. | 82 | 100 | 22 |
| Floor Expenses | 348 | 412 | 18 |
| Communications | 493 | 534 | 8 |
| Occupancy & Equipment | 504 | 510 | 1 |
| Promotional Costs | 260 | 212 | (18) |
| Interest Expense | 3,201 | 3,160 | (1) |
| Losses - Errors and Bad Debts | 85 | 110 | 29 |
| Data Processing Costs | 129 | 146 | 13 |
| Non-recurring Charges | 60 | 5 | (92) |
| Regulatory Fees and Expenses | 77 | 62 | (19) |
| Other Expenses | 860 | 1,062 | 23 |
| Total Expenses | $10,123 | $10,950 | 8 |
| Pre-Tax Net Income | $1,474 | $1,945 | 32 |

*Based on NYSE firms doing a public business

But just maintaining today's lower 21% slice of revenues is not saying much for commission business. Since last August the underlying transactions for commission business, equity sales, have exploded. According to SIA's Investor Activity Report, the newest and most sophisticated measurement of member/institutional/retail trading activity which tracks actual institutional and member trades (and is not just an arbitrary proxy measurement), both overall equity business and the commission intensive retail equity business has skyrocketed in all markets from last August through the end of the first quarter. For the Big Board, total share volume doubled during this period while its retail portion was up over 60%. For the AMEX, both overall and retail activity more than doubled while the OTC market showed similar gains in overall activity. Thus, last year's decline in commissions' contributions to all revenues and this past quarter's holding steady level is disappointing in the face of an exploding equity market. And since the explosion waned since March, the second quarter's showing may not even hold at 21%. Still, $2.8 billion is a lot of commission dollars and surely helped the bottom line.

The gain in trading gains' share of revenues is gratis of an exploding secondary debt market (where the preponderance of these revenues are made). SIA's Investor Activity Report also shows this market exploding (as measured by professional institutions' secondary trading of corporate debt). The gains could have even been more impressive if the muni market hadn't collapsed during the first quarter (see 4/9/86 TRENDS).

It was this muni fall-off which contributed to the only major drop-off in any revenue line...underwriting. The first quarter's 25% drop-off (compared to 1985 Q4) in underwriting revenues is directly attributable to a dead muni market. The corporate syndication sector was fine...in fact, it was booming. From January through March, underwriters booked nearly $70 billion of corporates, half of all 1985's business. But munis collapsed. Less than $12 billion made it through the first quarter window...only 5% of last year's total. Fortunately, munis so far are making a second quarter comeback while corporate continues at torrid levels.

The few other revenue lines which were down were down only slightly from 1985 Q4. Margin interest eased 1%, not bad considering a much more precipitous drop in interest rates during the quarter, while reduced M&A activity partly contributed to a 6% easing of securities related other revenue.

## COSTS CONTROLLED

The increase in the industry's major expense factor, people costs, averaged less than the increases in the industry's major revenue lines. Thus, the bottom line improved from both a relative and aggregate viewpoint. The bite out of revenues taken by RRs, clerks, partners and other employees' wages edged up slightly in 1986 Q1 from 1985 Q4, but was still less than full year 1985's bite or less than any full year during the Eighties for that matter.

The interest rate easing during the quarter, though it tempered revenues from margin interest, was counterbalanced when it reduced the income statement's biggest expense item, interest expense (since employee costs are sub-divided). That's pretty impressive since the liability side of the industry's balance sheet continued its rapid increase during this quarter. Average liabilities increased 15% to about $380 billion (from 1985 Q4 to 1986 Q1).

While some reduced expenses, such as a 92% cut in non-recurring charges, were beyond any conscious cost cutting abilities, others, such as an 18% drop in promotional costs, were indicative of the Street's efforts to not let costs run away from them during bull markets...a sign that maybe the boom/bust lesson has finally been learned.

## REMARKABLE RATIOS

All this rosy revenue, controlled cost analysis boils down to one thing...it was a great quarter. The ratio's were terrific. The first quarter's 44.5% pre-tax return on equity was only exceeded once on a full year basis since 1973 when data was first available. And that 44.5% didn't fall far short of the record pre-tax ROE, 1980's full year 49.2%. Even better, the quarter's 15.1% profit margin exceeds all full-year margins since the data became available in 1973. And while we don't wish to pay lip service to the fires of optimism, if that doesn't say enough about this record quarter and the current bull year, nothing else can.

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$48.00 member • $72.00 non-member

A8825-1

Vol. XII, No.7 July 17, 1986

## SIA TRENDS FLASH....EVEN A Q2 SLIP CAN'T STOP THIS RECORD

Some acts are hard to follow. The securities industry's first quarter record performance was one of the hardest. Based on the results of the Top 15 firms during April and May, this year's second quarter will show a precipitous 35% decline from Q1's $1.945 billion pre-tax profit (for NYSE firms doing a public business which historically account for about 85% of all securities firms' revenues).

That is not as disastrous as it sounds. The quarter will still turn in over a billion in pre-tax profits...$1.3 billion estimated. It will also be turning in revenues of over $12 billion...only the second time this much was raised (the first quarter's $12.895 billion being the first time). However, in Q2, the $11 billion barrier is projected to be broken for the first time ever for expenses, which cut a good slice out of the quarter's bottom line.

The Top 15's showing in May was well below April's heady levels which in no small part was due to some bad guess work on May's Treasury auction. The resultant revenue dive helped stall a march towards even higher revenue and profit figures in the quarter for individual firms and the largest 15 firms as a group.

But that still leaves the industry with a record half-year pre-tax profit performance of $3.2 billion. That's better than three-quarters of last year's full-year profit binge of $4.1 billion. This leaves less than $1 billion needed in profits over the second half to break last year's record year. So for those who have isolated Q2's downturn as a negative for this record year, just remember...two more quarters only half as good as the one just passed will put the industry over the top of historic profit years.

(over)

Securities Industry Association
[illegible] • New York, N.Y. [illegible] • [illegible]

# PROJECTED 1986 Q2 SECURITIES INDUSTRY PROFITS
(In $ Millions)

| | Top 15* | Actual Industry | % | Top 15* | Projected Industry** |
|---|---|---|---|---|---|
| | BASED ON Q1 1986 | | | Q2 1986 | |
| REVENUES | 5,863 | 12,895 | 45.5 | 5,712 | 12,554 |
| EXPENSES | 5,184 | 10,950 | 47.3 | 5,269 | 11,140 |
| PRE-TAX NET | - | - | - | - | 1,414 |
| PRE-TAX NET*** | 680 | 1,945 | 35.0 | 443 | 1,266 |
| | BASED ON FULL YEAR 1985 | | | | |
| REVENUES | 17,964 | 38,621 | 46.5 | 5,712 | 12,284 |
| EXPENSES | 16,371 | 34,481 | 47.5 | 5,269 | 11,093 |
| PRE-TAX NET | - | - | - | - | 1,191 |
| PRE-TAX NET*** | 1,592 | 4,140 | 38.5 | 443 | 1,151 |
| AVG PRE-TAX NET | | | | | 1,256 |

* For first two months of each quarter

** Applies the prior period Top 15 share of market to their Q2 1986 results. Also, subtracts projected expenses from projected revenue.

*** Differences due to rounding.

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A8825-1

Vol. XII, No. 8 August 11, 1986

# Capital Gains: If It Ain't Broke...

## Highlights

1. This *Trends* issue presents the well-documented success record of the 1978 and 1981 capital gains tax cuts. It's a familiar story, but one worth repeating despite the almost certainty of eliminating the differential.

2. An old fact: Treasury revenues have increased in every year since 1978 in response to lower capital gains taxes. A new point: Taxes paid on capital gains jumped 45.8% to $18.8 billion in 1983 from $12.9 billion in 1982.

3. An estimate of $19.3 billion is cited by government staff as the amount of revenue to be raised by the elimination of the capital gains exclusion. Both actual experience and recent studies, including the Treasury's, negate the magnitude of such an estimate.

4. Investment data -- shareownership, IPOs, venture capital, market indices -- support the position that lower taxes on savings and investment have contributed to the strength of the economy.

5. A comparison of 1973 and recently released 1981 holding period data on corporate stock show most investors invest for the long-term. For these two years, only 10% of gross gain was taken under the one-year mark, suggesting that estimates of revenues raised by imposing a barrier on the free flow of capital are unimportant. The elimination of the holding period is a step in the right direction; higher taxes on capital gains are not.

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## Introduction

Congress is near completion of its major effort to reform and simplify the tax code. Lower individual tax rates, the elimination of many provisions which lead to tax abuses, and the removal of millions of low income persons from the tax rolls are noteworthy accomplishments. Given the magnitude of the tax reform efforts now underway, within the tax conferees' decisions lies the path of future economic growth.

Indeed, economic growth is at the core of the tax reform movement. The radical transformation of the current tax code presents a unique challenge to those attempting to forecast economic growth. Some of the bill's effects will be immediate, others will take years to emerge. Many savings and investment incentives have been traded off for lower rates. Savings and investment perform a critical function in the growth process. True, lower rates should encourage individuals to save and invest more, but these lower rates will not necessarily foster risk-taking nor offset the erosion of inflation on assets.

Lower capital gains rates have proved effective and efficient at stimulating savings and investment. Historical experience documents the beneficial economic consequences of investment incentives in the tax code. Moreover, the revenue data since the 1978 and 1981 capital gains tax cuts should prove that substantial revenues cannot be derived from higher capital gains rates. All evidence supports the position that lower capital gains taxes have contributed to the strength of our economy. To raise capital gains taxes is to damage a proven tool for fostering economic growth.

The following presents the well-documented success story of lower capital gains taxes. The capital gains story is a familiar one to many, but evidently not familiar enough to some who, though concerned with economic growth, are considering higher capital gains taxes.

## Impact of Capital Gains
## Tax Changes
## 1978 & 1981

The Revenue Act of 1978, through an increase in the capital gains tax exclusion from 50% to 60% and other changes, cut the maximum capital gains tax rate from 49% to 28%. Congress enacted that legislation because the high tax rate on capital gains contributed to a shortage of funds for capital formation, a decline in economic growth and a deterioration in the competitive position of the U.S. The 1981 drop in marginal tax rates enhanced the returns from savings and investment and reduced the maximum tax on capital gains to 20%.

Although no one factor is responsible for the decision to save or invest, the after-tax return on investment is clearly a prime consideration. The capital gains tax cuts of 1978 and 1981 improved after-tax returns, thus fostering conditions for increased savings and investment. Among the considerable evidence supporting the effectiveness and efficiency of these cuts are dramatic increases in initial public offerings and the pool of venture capital. Funds raised in these markets have allowed budding enterprises to develop and underscore the positive impact the 1978 and 1981 capital gains tax cuts had on capital formation.

Table I

Initial Public Offerings
($ millions)

| Year | Number of Issues | Share Value |
|---|---|---|
| 1977 | 40 | $ 153 |
| 1978 | 46 | 250 |
| 1979 | 81 | 506 |
| 1980 | 237[1/] | 1,397 |
| 1980 | 152[2/] | 1,400 |
| 1981 | 355 | 3,200 |
| 1982 | 124 | 1,400 |
| 1983 | 687 | 12,500 |
| 1984 | 354 | 3,900 |
| 1985 | 360 | 8,600 |
| 6/86 | 281 | 8,800 |

---

Sources: Going Public and Investment Dealers' Digest.

[1/] Going Public
[2/] Investment Dealers' Digest

Note: Going Public has been incorporated into IDD. IDD's data base on IPOs starts with 1980 and is not strictly comparable with the Going Public data base.

## Initial Public Offerings

After the 1978 capital gains cut, the increased market value placed on the stocks of smaller companies produced a market climate conducive to the initial public offerings (IPOs) of new and emerging companies. The public was willing to provide emerging companies with equity for expansion and investment. In contrast, with increased capital gains taxes in the late 1960s came the almost complete evaporation of the IPO market.

From 1969 to 1975, the number of issues and amount of dollars raised in the new issue market plunged 99%, from 548 issues raising $1,457.7 million to 4 issues raising $16.2 million. In the first half of 1978, only 16 companies went public, raising a meager $64.2 million. When passage of the Revenue Act was imminent in the second half of 1978, 29 companies came to market, raising three times the capital obtained during the first half. From 1979 to 1985, the number of companies going public increased impressively and the amount of money raised soared.

During this period, 1983 marked an exceptional year. Boosted by initial public offerings of thrift institutions converting from mutual to stock companies, new issues numbered 687 and funds raised totaled $12.5 billion. Moreover, despite adverse market conditions, 1984 saw an impressive 354 companies go public, raising $3.9 billion. In 1985, a dramatic $8.6 billion was raised by 360 IPOs and, at the half-year mark, new dollars invested in growing companies in 1986 already exceeded the 1985 amount.

## Venture Capital

Venture capital is a critical link in the process of entrepreneurship, business formation, and small firm expansion through innovative activity.1/ Following the 1969 capital gains tax increase, new funds committed to venture capital firms averaged only $58 million in the 1970-77 period, reaching a peak of $97 million in 1970 and a low of $10 million in 1975. The size of the venture capital pool virtually stagnated during that period at an estimated $2.5-$3.0 billion.

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1/ The State of Small Business: A Report of the President, May 1985

## Table II

### Venture Capital Committed & Disbursed ($ Millions)

| Year | Net New Private Capital Committed to Venture Capital Firms[1] | Size of Total Pool | Estimated Disbursements to Portfolio Companies |
|---|---|---|---|
| 1977 | $ 39 | $2,500-3,000 | $ 400 |
| 1978 | 600 | 3,500 | 550 |
| 1979 | 300 | 3,800 | 1,000 |
| 1980 | 700 | 4,500 | 1,100 |
| 1981 | 1,300 | 5,800 | 1,400 |
| 1982 | 1,800 | 7,600 | 1,800 |
| 1983 | 4,500 | 12,100 | 2,800 |
| 1984 | 4,200 | 16,300 | 3,000 |
| 1985 E | 3,000 | 19,300 | 2,600 |

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Source: Venture Economics, Inc.

[1] Total net private capital less capital withdrawals.

In 1978, however, venture capital firms raised a striking $600 million. After dipping to $300 million in 1979, venture capital committed leaped to $700 million in 1980, $1.3 billion in 1981, and reached a high of $4.5 billion in 1983. Commitments in 1984 and 1985 were $4.2 billion and an estimated $3.0 billion, respectively. The venture capital pool has expanded dramatically from $3.5 billion in 1978 to an estimated $19.3 billion in 1985.

Correspondingly, disbursements have climbed significantly, with an estimate of almost $6 billion disbursed to new businesses in 1984 and 1985. Of these recent disbursements, almost three-fourths went to computer, electronics, communications and medical health care related companies. Venture capital experts believe that the vigorous and sustained expansion of the venture capital industry resulted primarily from government actions that: (1) reduced the capital gains tax in 1978; (2) relaxed pension trust investment rules in 1979; and (3) further reduced the maximum tax on investment income from 70% to 50% in 1981.

## Table III
## Shareownership

| Survey Year | Shareowners (millions) | % Change | Shareowners as % of Population |
|---|---|---|---|
| 1965 | 20.1 | -- | -- |
| 1970 | 30.9 | 53.3% | 15.1% |
| 1975 | 25.3 | (18.1) | 11.9 |
| 1980 | 30.2 | 19.5 | 13.5 |
| 1981 | 32.3 | 6.8 | 14.4 |
| 1983 | 42.4 | 31.3 | 18.1 |
| 1985 | 47.0 | 11.0 | 20.1 |

Source: NYSE

### Shareownership

The number of individuals owning stocks has waxed and waned with the tax burden on investment income. Shareownership as reported by the NYSE climbed steadily for almost two decades, reaching a peak in 1970 of 30.9 million individuals, or 15.1% of the population. With increased taxes on capital gains in the 1969-77 period, shareownership diminished. From 1970 to 1975, shareownership dropped 18% to 25.3 million individuals, or 11.9% of the population. However, by mid-1980, shareownership was on an uptrend, one that has continued until at least mid-1985, the latest survey period. At mid-1985, 47.0 million individuals directly owned stock or mutual funds, representing 20% of the population. This figure excludes "indirect" shareownership; that is those individuals who participate in pension plans with huge investments in the equity markets.

### Stock Market Indices

Lower taxes on investment income have played a major role in stimulating new shareownership. The increased value placed on the stocks of smaller companies has produced market conditions encouraging entrepreneurship and innovation.

In most years since 1977 the stock market indices have scored healthy gains. Of particular note is the impressive rise of the NASDAQ Index, which represents smaller companies and attracts the individual investor hoping for investment return in the form of capital gains. In years of rising markets, the NASDAQ Index has outpaced both the S&P 500 Index and the NYSE Common Stock Index. In 1985, all major market indices increased by over 20%, but the NASDAQ Index chalked up a gain of over 30%.

## Table IV

## Stock Market Indices

| Period | S&P 500 Index | NYSE Common Stock Index | AMEX Market Value Index | NASDAQ Index |
|---|---|---|---|---|
| 12/78-12/79 | 12.3% | 15.5% | 64.1% | 28.1% |
| 12/79-12/80 | 25.8 | 25.7 | 41.3 | 33.9 |
| 12/80-12/81 | (9.7) | (8.7) | (8.1) | (3.2) |
| 12/81-12/82 | 14.8 | 13.9 | 5.7 | 18.7 |
| 12/82-12/83 | 17.3 | 17.5 | N.C | 19.9 |
| 12/83-12/84 | 1.4 | 1.3 | (8.4) | (11.2) |
| 12/84-12/85 | 26.3 | 26.1 | 20.5 | 31.4 |

## International Tax Treatment of Capital Gains

In 1978, the trend of taxation of investment income in the U.S. made a distinct turn. Shifting from a system that penalized savings and investment -- with capital gains rates as high as 49% and marginal tax rates of 70% on interest and dividends -- the U.S. has reduced the tax burden on savings and investment in recent years. These positive steps brought the U.S. treatment of savings and investment closer to that of foreign countries. Nevertheless, an SIA-commissioned study by Arthur Andersen & Co. of the international tax treatment of capital gains showed that the U.S. tax system is harsher than that of major industrial countries and countries in the Pacific Basin, one of the fastest growing economic areas in the world.

Of the sixteen foreign countries reviewed, nine exempt capital gains completely from taxation. In terms of the maximum tax rate applying to short-term capital gains, only two countries apply a rate higher than the U.S. Sweden uses the same rate as the U.S. Australia sets a 61% tax on short-term gain, with a one-year holding period required for tax exemption as a long-term gain. Moreover, Germany, with a 56% short-term rate, requires six months for long-term gain exemption and exempts short-term gain up to DM 1,000 ($305+).[2] The remaining four countries taxing short-term gain apply rates ranging from 16% to 35%, substantially below the current U.S. maximum rate.

Eleven of the sixteen foreign countries exempt long-term capital gains from taxation. Of those countries taxing long-term gain, only two apply rates higher than the U.S. and Sweden uses a 20% rate. The U.K., however, offsets its 30% rate in part with an annual exemption of L 5,600 ($7,140). Canada and France apply rates of 17% and 16%, respectively, to short- and long-term gain. In addition, annual securities sales of under FF 251,500 ($27,237) in France are exempt from capital gain taxation.

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[2] Conversions in this section as of April 15, 1985.

## Table V

## Comparison of Individual Taxation of Capital Gains on Portfolio Stock Investment in Industrialized & Pacific Basin Countries

| Country | Maximum Short-Term Capital Gain Tax Rate* | Maximum Long-Term Capital Gain Tax Rate* | Period to Qualify for Long-Term Gain Treatment | Maximum Annual Net Worth Tax Rate |
|---|---|---|---|---|
| United States | | | | |
| Current Law | 50% | 20% | Six Months | None |
| House Bill | 38% | 22% | " " | " |
| Senate Finance Bill | 27% | 27% | None | " |
| **Industrialized Countries** | | | | |
| Australia | 61% | Exempt | One Year | None |
| Belgium | Exempt | Exempt | None | None |
| Canada | 17% | 17% | None | None |
| France*1 | 16% | 16% | None | 2% |
| Germany | 56% | Exempt | Six Months | .5% |
| Italy | Exempt | Exempt | None | None |
| Japan | Exempt | Exempt | None | None |
| Netherlands | Exempt | Exempt | None | .8% |
| Sweden | 50% | 20% | Two Years | 3% |
| United Kingdom*2 | 30% | 30% | None | None |
| **Pacific Basin** | | | | |
| Hong Kong | Exempt | Exempt | None | None |
| Indonesia | 35% | 35% | None | .5% |
| Malaysia | Exempt | Exempt | None | None |
| Singapore | Exempt | Exempt | None | None |
| South Korea | Exempt | Exempt | None | None |
| Taiwan | Exempt | Exempt | None | None |

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Note: Based on exchange rates on April 15, 1985. Special allowances or exemptions upon conversion to U.S. dollars may appear less generous than intended by deliberate public policy due to the strong position of the U.S. dollar since our last comparative international study in June 1983.

* State, provincial and local tax rates not included.

*1 Gains from proceeds of up to $27,237 (FF 251,500) are exempt from taxation in a given taxable year.

*2 The first $7,140 (L 5,600) of gain is exempt annually.

## Revenue Impact

The experience since 1978 should be incorporated into any assessment of the revenue impact of a change in capital gains taxation.

Prior to the 1978 capital gains tax cut, opponents of the cut argued two main points. First, capital gains tax revenues would decline because of the lower rates and, second, any spurt in gains realized from 1978 to 1979 would be a one-time phenomenon, with gains drifting to lower levels by 1980. The following data disprove both arguments. Actual experience demonstrates the fallacy of the static revenue estimation technique, which assumes that loophole closings and lower rates will have no effect whatever on the behavior of taxpayers, the growth of taxable income or anything else in the economy.[3] To assume that individuals do not respond to tax changes defeats the very purpose of tax reform!

### Revenues

Capital gains tax revenues collected in 1979 and 1980 exceeded Treasury projections for those years before passage of the 1978 Revenue Act. Moreover, taxes paid on capital gain income continued to increase in 1981 and 1982. The 1982 revenue figure is notable as the phase-in of lower marginal tax rates as established in the 1981 Tax Act had begun and the U.S. was in the midst of a recession. The impressive 1983 level may represent a new plateau. Capital gain revenues spurted 45.8% in 1983 to $18.8 billion from the 1982 figure. Based on actual total gains of $140.5 billion, the American Council on Capital Formation estimates the 1984 tax take at $21.6 billion.

### Realizations

Capital gains rate reductions have prompted dramatic increases in realizations. From 1978 to 1979, realizations jumped 45.3% to $73.4 billion. By comparison, total capital gains realized increased 11.5% to $50.5 billion in 1978 from $45.3 billion in 1977. Total realizations have continued to rise from the 1979 plateau. The Economic Recovery Tax Act of 1981, which cut the maximum tax on investment income to 50%, further encouraged realizations. Realizations in 1982 were $90.2 billion, representing an 11.5% increase from the 1981 figure. In addition, based on data from the Statistics of Income series, 1983 sales of capital assets jumped 43.6% to $49.4 billion from the 1982 level of $34.4 billion and increased almost 7% to $52.8 billion in 1984.

---

[3] "Tax Reform, An Editorial Series," The Wall Street Journal, April 1985.

Table VI

Revenues and Realizations
($ Billions)

| | SOI Series | Treasury Series | | |
|---|---|---|---|---|
| | Sales of Capital Assets (net gain less loss) | Total Gains | Taxes Paid on Capital Gain Income | Effective Tax Rates |
| 1977 | $20.8 | $45.3 | $8.1 | 17.88% |
| 1978 | 23.2 | 50.5 | 9.3 | 18.50 |
| 1979 | 28.4 | 73.4 | 11.7 | 15.89 |
| 1980 | 29.7 | 74.6 | 12.5 | 16.71 |
| 1981 | 30.8 | 80.9 | 12.7 | 15.61 |
| 1982 | 34.4 | 90.2 | 12.9 | 14.31 |
| 1983 | 49.4 | 122.0 | 18.8 | 15.41 |
| 1984 | 52.8 | 140.5 | 21.6[1] | 15.41[1] |

Source: Statistics of Income Bulletin and Office of the Secretary of the Treasury, Office of Tax Analysis.

[1] American Council on Capital Formation estimate.

## Recent Studies

Many studies on the effects of the 1978-81 capital gains tax reductions have been done. Most observers agree with the conclusion of Treasury's study on the 1978 cut: The findings suggest that long run annual revenue from capital gains taxes either increased or declined only slightly as a result of the capital gains tax reductions in the 1978 and 1981 Acts.[4] In other words, the revenue effect of these changes in capital gains tax rates was minimal. Treasury also stated that, within the parameters of current tax law, any effort to raise substantial revenue by increasing capital gains tax rates is likely to be ineffective.

Using approximate relationships between realizations and tax rates as estimated in the Treasury study, deSeve Economics Associates studied the revenue impact of changes in capital gains taxation as contained in the President's proposal and the House bill.[5] The results indicated that in response to the capital gains increase in the House bill, taxpayers will reduce realizations to such a degree that 99% of the static revenue increase will be offset over the five-year budget period. In the first three years of such an increase, capital gains revenues will actually be lower. The capital gains tax reduction in the President's proposal would have a negligible revenue impact over five years, with revenues increasing in the first three years.

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[4] Report to Congress on the Capital Gains Reductions of 1978, Office of the Secretary of the Treasury, Office of Tax Analysis, September 1985.

[5] The Effect of Proposed Capital Gains Tax Rate Increases on Federal Individual Income Tax Revenues, deSeve Economics Associates, Inc., May 1986.

In addition, a recent paper by Lawrence Lindsey of the National Bureau of Economic Research examined the effects of capital gains tax rate changes on realizations and revenues.[6] The paper concluded that capital gains tax revenue is probably maximized at a rate below 20%. Considering data on reported gains, an increase of 8.4% was cited for a one percentage point cut in the capital gains rate in the first year and a 5.4% increase was implied for the long term. This particular result suggested that a stable capital gains rate of 18.5% would produce the maximum revenue in the long run.

Considerable experience, actual and theoretical, continues to mount on the behavioral responses of taxpayers to changes in the capital gains tax rate. The "lock-in" effect of high capital gains tax rates is a very real phenomena. An estimate of $19.3 billion is being quoted as the amount of revenues to be raised over a five-year period by the elimination of the capital gains exclusion. Both actual experience and recent studies, including the government's, negate such an estimate.

## Distribution of Realizations & Total Tax Liability

There were two distinct shifts in the distribution of net long-term capital in the 1977-1983 period. Until 1979, capital gains were centered in the $30,000 to $100,000 income class, with the largest percentage received by the $30,000-$50,000 AGI group. Realizations in 1979 increased dramatically and, with that increase, a shift occurred in the distribution of gains. While all income groups reported more realizations, the relative share of the top income group rose significantly.

In 1982, the reduction of the capital gains tax rate had a similar effect. The $200,000-and-over income group realized almost 42% of capital gains in 1982 and 40% in 1983. The volume and value of realizations in any given year are affected by many factors, including economic and market conditions as well as taxes. However, the data indicate that upper income individuals were very inclined to realize capital gains in 1979 and 1982, the first years following reductions in rates.

---

[6] "Capital Gains: Rates, Realizations, and Revenues", NBER Summary Report, 1986.

## Table VII

## Distribution of Gains

### Net Long-Term Capital Gain in Excess of Net Short-Term Loss
(All Returns, $ Billions)

| AGI ($000) | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 |
|---|---|---|---|---|---|---|---|
| 0-10 | $ 5.8 | $ 5.7 | $ 6.9 | $ 6.8 | $ 8.4 | $ 8.4 | $ 10.5 |
| 10-20 | 6.3 | 6.8 | 7.0 | 7.2 | 5.5 | 4.9 | 6.1 |
| 20-30 | 6.0 | 6.7 | 7.6 | 6.7 | 6.1 | 4.5 | 7.5 |
| 30-50 | 7.4 | 8.6 | 11.0 | 9.4 | 9.6 | 9.0 | 12.8 |
| 50-100 | 6.8 | 7.9 | 10.7 | 11.9 | 13.0 | 12.9 | 18.4 |
| 100-200 | 4.2 | 5.2 | 7.6 | 8.2 | 9.9 | 10.5 | 14.3 |
| 200+ | 7.4 | 7.6 | 19.5 | 19.7 | 24.5 | 36.0 | 46.4 |
| Total | $ 43.9 | $ 48.6 | $ 70.5 | $ 69.9 | $ 77.1 | $ 86.1 | $116.0 |

| AGI ($000) | % of Total | % of Total | % of Total | % of Total | % of Total | % of Total | % of Total |
|---|---|---|---|---|---|---|---|
| 0-10 | 13.2% | 11.8% | 9.8% | 9.7% | 10.9% | 9.7% | 9.1% |
| 10-20 | 14.4 | 14.0 | 10.0 | 10.3 | 7.1 | 5.7 | 5.2 |
| 20-30 | 13.7 | 13.8 | 10.8 | 9.7 | 7.9 | 5.2 | 6.5 |
| 30-50 | 16.8 | 17.7 | 15.6 | 13.4 | 12.5 | 10.4 | 11.0 |
| 50-100 | 15.5 | 16.3 | 15.2 | 17.0 | 16.9 | 15.0 | 15.9 |
| 100-200 | 9.6 | 10.7 | 10.8 | 11.7 | 12.9 | 12.2 | 12.3 |
| 200+ | 16.8 | 15.7 | 27.7 | 28.2 | 31.8 | 41.8 | 40.0 |
| Total | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% |

Note: Figures may not add to total due to rounding.

Source: Statistics of Income

Increased realizations have translated to higher Treasury revenues. Even with the decline in the maximum capital gains tax rate in 1978 and 1981, the amount of revenues raised increased. While realizations since 1978 have been centered in the upper income group, these individuals are subject to proportionately higher tax rates. More, not less, revenue has been generated by those realizing capital gains in recent years despite reduced capital gains rates.

Table VIII shows returns and tax liability of AGI groups as a percentage of the respective totals. Although the proportion of returns filed by the over $100,000 income groups remained relatively the same in 1981 and 1982, the share of tax liability for these classes increased in 1982 despite a lower maximum tax rate. In 1983, there was both an increase in return filed in the $50,000 and above income groups, from 5.6% to 6.6% of total returns, and a corresponding increase in tax liability of these groups from 35.4% in 1982 to 39.1% of the total.

The concentration of capital gains in the upper income strata raises the argument that reduced capital gains taxes benefit only the rich. It is true that wealthy individuals benefit from a lower rate on capital gains in the sense that, if they had realized the same amount of capital gains at ordinary income tax rates, their tax liability would be higher.[7] However, most capital gains would not in fact be realized at higher rates, as investors would simply hold on to their assets rather than selling them. No tax revenue is derived from unrealized "paper" gains. This "lock-in" effect has serious implications for the efficient allocation of capital and retards tax revenues.

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[7] Bruce Bartlett, "The Federal Tax Debate: Capital Gains," Backgrounder, The Heritage Foundation, 12/27/84.

## Table VIII

## Total Returns & Tax Liability by AGI Group

| AGI ($000) | 1980 | | 1981 | | 1982 | | 1983 | |
|---|---|---|---|---|---|---|---|---|
| | % of Total | | % of Total | | % of Total | | % of Total | |
| | Returns | Tax | Returns | Tax | Returns | Tax | Returns | Tax |
| 0-10 | 26.8% | 3.6% | 25.1% | 3.1% | 25.5% | 2.9% | 23.3% | 2.5% |
| 10-20 | 33.3 | 16.1 | 31.8 | 14.1 | 30.4 | 12.7 | 30.4 | 11.7 |
| 20-30 | 21.1 | 21.4 | 20.8 | 19.6 | 20.4 | 18.8 | 20.2 | 16.8 |
| 30-50 | 14.6 | 27.8 | 17.1 | 30.3 | 17.5 | 30.2 | 19.5 | 29.9 |
| 50-100 | 3.4 | 15.8 | 4.4 | 17.9 | 4.7 | 18.1 | 5.5 | 19.4 |
| 100-200 | 0.6 | 7.7 | 0.7 | 7.5 | 0.7 | 7.8 | 0.8 | 8.0 |
| 200 + | 0.2 | 7.6 | 0.2 | 7.5 | 0.2 | 9.5 | 0.3 | 11.7 |
| | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% |

Note: Figures may not add to total due to rounding

Source: *Statistics of Income*

## Summary

Notable progress has been made in hammering out a simplified tax system. However, Congress must not lose sight of those policy which have encouraged and supported the economic growth of the 1980s. Savings and investment have provided the underpinnings of this growth. Considerable data exist that prove the beneficial consequences of lower capital gains taxes.

The 1978 and 1981 capital gains tax cuts provided a climate conducive to entrepreneurship and the development of new companies and new technologies. Moreover, these cuts provided Treasury with increased revenues. We must continue policies that have proven effective and efficient in encouraging savings and, ultimately, healthy economic growth.

Carolyn Hildebrandt
Assistant Vice President

VOLUME

| | JUNE 1986 | JAN - JUNE 1986 | JUNE 1985 | JAN - JUNE 1985 | % CHAN. J-J 1985-1986 |
|---|---|---|---|---|---|
| AVERAGE DAILY SHARE VOLUME ON | | | | | |
| NYSE (MILS.)* | 126.2 | 140.5 | 105.9 | 107.8 | 30.3% |
| AMEX (MILS.)* | 12.8 | 13.2 | 7.1 | 8.3 | 59.0% |
| NASDAQ (MILS.)* | 123.4 | 121.3 | 80.7 | 79.8 | 52.0% |
| REGIONAL EXCHANGE (MILS.)* | 21.0 | 21.8 | 18.1 | 17.6 | 23.9% |
| DOLLAR VALUE OF SHARES TRADED ON | | | | | |
| NYSE (MILS.) | $104,248 | $676,496 | $76,465 | $472,973 | 43.0% |
| AMEX (MILS.) | 4,122 | 22,672 | 1,864 | 12,572 | 80.3% |
| ODD-LOT SHARES PURCHASED ON NYSE (THOUS.) | 8,791 | 55,931 | 6.874 | 41.549 | 34.6% |
| ODD-LOT SHARES SOLD (INCLUDING SHORT SALES) ON NYSE (THOUS.) | 14,984 | 111,673 | 14,261 | 94,393 | 18.3% |
| NYSE BLOCK VOLUME AS A PERCENT OF TOTAL SHARES TRADED | 49.5% | 49.3% | 52.0% | 51.4% | ---- |
| CONTRACTS TRADED (THOUS.) | | | | | |
| CBOE OPTIONS | 13,519 | 93,621 | 11,489 | 70,685 | 32.4% |
| AMEX OPTIONS | 3,406 | 24,154 | 2,574 | 16,585 | 45.6% |
| COMMODITY | 15,832 | 95,779 | 13,179 | 78,400 | 22.2% |

*MONTHLY AVERAGE
N/A - DATA NOT AVAILABLE

## YIELDS

(MONTHLY AVERAGES

| | JUNE 1986 | JUNE 1985 | BASIS POINT CHG. 1985-1986 |
|---|---|---|---|
| BOND BUYER INDEX (20 BOND) | 7.87 | 8.69 | (82) |
| CORPORATE BOND YIELDS (MOODY'S) | | | |
| Aaa CORPORATE | 9.13 | 10.94 | (181) |
| Baa CORPORATE | 10.34 | 12.40 | (206) |
| RATIO Aaa CORPS. TO Baa CORPS. | 0.88 | 0.88 | 0 |
| MUNICIPAL BOND YIELDS (MOODY'S) | 7.87 | 8.69 | (82) |

## PRICES

(END OF MONTH)

| | JUNE 1986 | JUNE 1985 | % CHAN. Y-T-D 1985-1986 |
|---|---|---|---|
| DOW JONES INDUSTRIALS | 1892.72 | 1335.46 | 41.73% |
| STANDARD & POOR'S 500 | 250.84 | 191.85 | 30.75% |
| NYSE COMPOSITE | 143.96 | 111.11 | 29.57% |
| AMEX MARKET VALUE INDEX | 284.20 | 230.89 | 23.09% |
| VALUE LINE COMPOSITE | 245.37 | 200.35 | 22.47% |
| NASDAQ COMPOSITE | 405.51 | 296.20 | 36.90% |

UNDERWRITING
(DOLLARS IN MILLIONS)

| | 1986 FIRST HALF | 1985 FIRST HALF | 1985-1986 % CHANGE |
|---|---|---|---|
| CORPORATE FINANCING (Gross New Issues) | | | |
| Total | $144,323.6 | $57,566.0 | +150.7 |
| Common Stock | $ 23,338.0 | $11,085.1 | +110.5 |
| # of Common Stock Issues | 587 | 332 | + 76.8 |
| Preferred Stock | $ 6,642.9 | $ 3,108.3 | +113.7 |
| # of Preferred Stock Issues | 85 | 48 | + 77.1 |
| Corporate Debt | $114,345.2 | $43,372.6 | +163.6 |
| # of Corporate Debt Issues | 1,149 | 582 | + 97.4 |
| MUNICIPAL FINANCING (Gross New Issues) | | | |
| Total | $48,169.0 | $58,160.3 | -17.2 |
| # of issues | 1,026 | 1,722 | -40.4 |

Source: IDD Information Services, Inc.

MARGIN DEBT

| | JUNE 1986 | JUNE 1985 | % CHANGE 1986-1985 |
|---|---|---|---|
| MARGIN DEBT OUTSTANDING ($MILS) | 32,480 | 25,260 | +28.6 |
| NET CHANGE IN MARGIN DEBT ($MILS) | 7,220 | 1,810 | +298.9 |
| % OF ACCOUNTS WITH EQUITY UNDER 40% | 11% | 10% | ------ |

* ALL TIME HIGH

## RECENT INTERESTING READING AND STATISTICAL MATERIAL

| Item | Description | Source |
|---|---|---|
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| Achieving Excellence in Managing | An edited transcript of the presentations and discussions on management given at the SIA Regional Conference on March 25-26, 1986. Discussions focused on management principles, concepts, strategies and applications, including how to motivate and encourage employees to make that extra effort that will distinguish a firm from its competition. Speakers included top industry executives as well as outside consultants, Peter Drucker and Jerry Wind. | SIA<br>Publications Department<br>Cost: $100 - SIA Members<br>$200 - Non-Members |
| "Comparison of House and Senate Bills..." | The Joint Committee on Taxation's document providing a side-by-side comparative description of tax reform provisions as proposed by the President, the House bill and Senate bill as well as present law. | Special Supplement-DER No.<br>July 18, 1986<br>Customer Service<br>The Bureau of National Af<br>9435 Key West Ave.<br>Rockville, MD 20850<br>Price: $20.00<br>Quantity discounts availa |
| "The 1986 CFO directory" | Institutional Investor's annual listing of the top financial officers at more than 500 key companies. | Institutional Investor<br>July 1986 |

| | | |
|---|---|---|
| "Global Investment Banking ...Citicorp Style" | Top managers in Citicorp's investment bank discuss plans for global investment banking. "The crucial distinguishing feature is that you must have massive amounts of capital...and the will and the skill to trade it." Citicorp believes it has all three characteristics. | Investment Decisions<br>June 1986 |
| "The Forbes Foreign Rankings" | A comprehensive statistical picture of the scope and scale of global business today. A list of the 500 largest foreign companies "The Forbes Foreign 500", with $3.19 trillion in revenues among them, are ranked in order of revenues, alphabetically and by 33 industry groups. Also covered are the 100 largest U.S. multinationals. | Forbes<br>July 1986 |
| "Investment Banks" | A hard look at the fast growing and fast changing investment banking world from the aspect of management. Author observes few on Wall Street have had to think how best to run tomorrow's business, so concentrated have minds been on making today's profit. Given explosive growth, high leveraging, and other grounds for caution, author concludes the management issue best be addressed right now. | The Economist<br>July 5, 1986 |
| "The Senate's Proposed Book Income Minimum Tax Preference" | Article addresses some of the policy and technical aspects of the alternative minimum tax in the Senate tax reform bill which defines tax preferences to include one-half of the difference between book income and taxable income. Conclusion suggests earnings and profits would be a vastly preferable alternative. If this provision is not changed in Conference, it will have serious implications for the securities industry. | Tax Notes<br>August 11, 1986 |

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**Trends**
AN ANALYSIS OF EMERGING TRENDS IN THE SECURITIES INDUSTRY
Produced by the SIA Research Department

A8825-1

Vol. XII, No.9 September 10, 1986

# The Changing Pattern of Credit Flows in the 1980s: A Review Article

## Highlights

1. This *Trends* issue summarizes a recent article in the *Federal Reserve Bulletin* which presents a broad overview of the major borrowing and lending trends in the U.S. economy in 1981-85. In addition, international capital flows and the role of the foreign investor is examined.

2. Demands for funds have risen at an unusually rapid rate in recent years, giving rise to a sharp expansion of debt. Total credit market debt of all sectors grew from $4.7 trillion to $8.2 trillion between 1980 and 1985.

3. In 1979 and 1980, the growth rate of Federal debt was a little less than 12% each year. This rate accelerated to 19 1/2% between 1981 and 1982. While the dollar value of Federal borrowing has increased in every year since, the rate of debt growth has slowed to 16%.

4. Household debt growth has exceeded that of disposable personal income in the 1980-85 period. Since 1980, the increase in income has averaged about 8% per year, while debt has grown at an average rate of 10 1/2%.

5. Much of the growth in corporate business debt, especially during the past two years, can be attributed to the massive volume of equity retirements associated with a heavy wave of mergers, acquisitions, LBOs and share repurchases. Between 1983 and 1985, about $200 billion in stock of nonfinancial corporations was taken off the market in this fashion.

6. In 1985, the international investment position of the U.S. swung into the negative for the first time since recorded statistics were begun in 1919. Foreign assets in the U.S. outweighed U.S. assets abroad by $107.4 billion. Interestingly, it is estimated that U.S. investors owned $114.1 billion of foreign corporate securities as compared to foreign holdings of $207.8 billion of such U.S. securities at year-end 1985.

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## Introduction

Much has been written about the mounting levels of overall debt in recent years. Yet little has been published giving a comparative perspective on this increasing demand for credit and the changing suppliers of these funds.

This *Trends* issue summarizes a recent article in the *Federal Reserve Bulletin* which presents a broad overview of the major borrowing and lending trends in the U.S. economy in 1981-85.[1] The article traces and measures the uses and sources of credit market funds in these years, reviews the reasons for certain shifts, and discusses structural changes which they have precipitated. In addition, an in-depth look at international capital flows and the role of the foreign investor has been added. As such, this *Trends* issue presents a general picture of financial developments in the U.S. economy in recent years. It should serve to answer countless questions concerning the players in today's credit markets, the pace of debt growth, and how significant the foreign investor is to the U.S. economic picture.

## Uses of Funds in Credit Markets

Demands for funds by all sectors of the U.S. economy typically grow with economic activity. However, such demands have been unusually strong in recent years, giving rise to a sharp expansion of debt. Total credit market debt of all sectors expanded from $4.7 trillion to $8.2 trillion between year-end 1980 and year-end 1985. Meanwhile, the debt of the domestic nonfinancial sector rose from $3.9 trillion to $6.9 trillion during the same period. The rapid debt growth has drawn attention to the increasing role of foreign capital in satisfying the credit demands in the U.S. capital markets.

Total debt relative to GNP was fairly stable during much of the postwar period. Since 1981, however, the growth of total debt has far outpaced the rate of expansion of domestic output. The unusual acceleration of debt in the 1980s was triggered by the heavy needs of the federal government during a period of deep recession. Since 1983, however, debt of the nonfederal sectors also has accelerated. On balance, as shown in Table 1, these developments have sharply raised the amount of debt in the economy relative to output. The ratio of total domestic nonfinancial debt to GNP has risen from 138% in 1980 to 169% at the end of 1985. Indeed, with the slowing of economic growth in the past two years, the debt ratio has climbed at an unprecedented rate.

---

[1] "Major Borrowing and Lending Trends in the U.S. Economy, 1981-85," *Federal Reserve Bulletin*, August 1986.

Table 1

Domestic Nonfinancial Debt and Borrowing

| Category | 1971-75, Average | 1976-80, Average | 1981 | 1982 | 1983 | 1984 | 1985 |
|---|---|---|---|---|---|---|---|
| | Annual percentage change, end-of-period basis | | | | | | |
| **Debt** | | | | | | | |
| Federal | 8.4 | 10.8 | 11.8 | 19.4 | 18.8 | 16.9 | 16.2 |
| Nonfederal | 10.1 | 11.7 | 9.0 | 6.8 | 9.7 | 14.0 | 14.6 |
| Households | 9.8 | 13.5 | 8.3 | 5.6 | 11.3 | 13.0 | 14.1 |
| Nonfinancial business | 11.0 | 11.8 | 11.1 | 7.6 | 7.7 | 15.4 | 11.3 |
| State & local govts. | 8.2 | 6.1 | 2.3 | 8.5 | 11.4 | 12.2 | 34.2 |
| Total | 9.7 | 11.6 | 9.5 | 9.2 | 11.6 | 14.7 | 15.0 |
| Growth of nominal GNP | 10.3 | 11.2 | 9.3 | 3.2 | 10.0 | 9.0 | 5.4 |
| | Average annual amounts, billions of dollars | | | | | | |
| **Net borrowing** | | | | | | | |
| Federal | 29 | 59 | 87 | 161 | 187 | 199 | 224 |
| Nonfederal | 139 | 274 | 285 | 234 | 356 | 567 | 674 |
| Households | 57 | 139 | 120 | 88 | 187 | 239 | 294 |
| Nonfinancial business | 68 | 120 | 159 | 120 | 131 | 283 | 240 |
| State & local govts. | 14 | 15 | 7 | 26 | 38 | 45 | 141 |
| Total | 168 | 333 | 373 | 395 | 543 | 766 | 898 |

## Federal Government

Federal borrowing in the flow of funds accounts is "net borrowing from the public," which excludes changes in holdings of government trust funds.[2] The amount of this borrowing differs from, and is usually higher than, the federal deficit in the national income and product accounts because of differences in geographic and financial coverage.

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[2] The flow of funds accounts, published by the Federal Reserve Board, measure the financial flows that accompany the economy's nonfinancial activities. The financial accounts present a statement of sources and uses of funds that correspond to national income concepts. Each sector of the economy receives income flows that support its current spending and saving. A sector's saving and net borrowing enable it to make investments which, through time, reflect collective preferences for tangible and financial assets in relation to liabilities.

Since 1981, several factors have contributed to unprecedented federal deficits. Large cuts in personal income taxes were enacted early in the period, and businesses were offered liberal depreciation allowances to stimulate capital formation. At the same time, there was a substantial defense buildup, and cuts in nondefense programs were not large enough to offset the rise in defense spending. Between 1981 and 1982, net federal borrowing from the public almost doubled, to $161 billion, and the growth rate of federal debt, which had been a little less than 12% in each of the previous two years, suddenly accelerated to 19 1/2%. The dollar value of federal borrowing has continued to rise in each year through the subsequent economic recovery -- to $224 billion in calendar 1985 -- although the percentage growth rate of federal debt has tapered off to about 16%. For the 1981-85 period as a whole, net federal demands on credit markets totaled $858 billion.

## Households

The rate of growth of household debt slowed each year from 1979 to 1982, but it has outpaced GNP growth each year since, surging more than 14% in 1985 (Table 1). In addition, household debt growth exceeded that of disposable personal income over the past five years. Since 1980, the increase in income has averaged about 8% per year, while household debt has grown at an average rate of 10 1/2%.

Since 1982, consumer credit has expanded rapidly, with annual increases of 14% to 20% in the 1983-85 interval. Net borrowing for home mortgages, which had averaged about $100 billion per year during the late 1970s, dropped to half that amount during the 1982 downturn; it subsequently picked up sharply, increasing to $155 billion in 1985 with the decline in interest rates and the revival of residential construction activity.

## Nonfinancial Business

Debt of nonfinancial businesses has grown less rapidly in the 1980s -- about 10 1/2% per year on average -- than in the previous decade, and it has shown considerable year-to-year volatility.[3] Nonetheless, business borrowing, which totaled $930 billion in the 1981-85 period, has exceeded apparent financing needs.

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[3] Although the business sector of the flow of funds accounts includes farms and unincorporated enterprises, the dollar volume of transactions in the sector is dominated by nonfinancial corporations, and the following discussion focuses on these entities.

The borrowing needs of corporations are often measured by the so-called financing gap, that is, the difference between capital expenditures and internal funds (retained earnings and depreciation allowances) (Table 2). This indicator of external financing needs climbed to around $60 billion during the 1979-81 period, but during the past four years it has averaged $27 billion. On average, nominal spending on fixed investment by corporations rose 8 1/2% per year during the 1981-85 period, only half the inflation-fueled annual rate of the previous four years. Internally generated funds have been relatively ample. Pretax profits measured on an economic basis rose to record levels during the 1983-85 period, and depreciation continued to grow, also contributing to cash flow in the business sector. Notwithstanding these favorable developments, nonfinancial corporations borrowed about 3 1/2 times the total financing gap during this period (Table 2).

Much of the growth in corporate business debt -- especially during the past two years -- can be attributed to the massive volume of equity retirements associated with the heavy wave of mergers, acquisitions, leveraged buyouts, and share repurchases that occurred throughout the economy. Between 1983 and 1985 approximately $200 billion in stock of nonfinancial corporations was taken off the market in this fashion. Although it is not always possible to link borrowing directly to equity retirements, in many cases (notably some mergers involving companies with more than $1 billion in assets) large bank financings, commercial paper issues, and bonds were used for such purposes. Moreover, indications from

Table 2

Financing Gap and Funds Raised in Markets by Nonfinancial Corporations
(Billions of Dollars)

| Year | Capital Expenditures | Internal Funds | Financing Gap | Credit Market Borrowing | Net Equity Issuance |
|---|---|---|---|---|---|
| 1981 | 311 | 250 | 61 | 104 | -11 |
| 1982 | 267 | 237 | 30 | 72 | 11 |
| 1983 | 281 | 277 | 4 | 56 | 28 |
| 1984 | 382 | 322 | 59 | 192 | -77 |
| 1985 | 369 | 353 | 17 | 166 | -82 |
| Total | 1,610 | 1,439 | 171 | 590 | -131 |

some large mergers suggest that, initially, the preponderance of equity retirements were financed by borrowing.[4] For the past two years at least, this activity has dominated the financing gap as the mainspring of business borrowing.

## State and Local Governments

Net borrowing by state and local governments has for some years moved up strongly despite the rising surpluses shown by these governments in the national income and product accounts. Borrowing soared from about $7 billion in 1981 to $45 billion in 1984 and to $141 billion in 1985. Nevertheless, during the last five years, investable surpluses of such governments averaged about $11 billion per year. The rapid pace of borrowing by these governments often has been influenced by refunding opportunities on outstanding debt, plans for future capital expenditures, and, before recent tightenings of rules on asset acquisition, even financing arbitrage. Actual and threatened restrictions have had a pronounced effect on the amount and timing of state and local financing for several years.

## Summary of Uses of Funds

As this overview suggests, special influences have caused federal borrowing and several important components of nonfederal borrowing to rise strongly in the past five years, contributing to the rapid rise in debt of both the federal and nonfederal sectors. Some of these influences appear to be waning, and there is little reason to believe that major surges and timing distortions in certain forms of debt will continue indefinitely. Legislation already in place is expected to have a restraining effect on federal borrowing and on tax-exempt debt for both public and private purposes.

## Supplies of Funds to Credit Markets

All told, domestic nonfinancial sectors have borrowed almost $3 trillion in credit markets during the past five years, and financial sectors of the economy have raised almost $600 billion more (excluding deposits at banks and thrifts). The supply of funds has expanded correspondingly, and sources have displayed noticeable shifts in origin. This discussion will cover the provision of credit market funds to all sectors, rather than to domestic nonfinancial sectors alone, because current data sources do not permit the isolation of issues of financial obligors from those of nonfinancial obligors in most debt-holders' portfolios. But since the largest portion of credit clearly flows to nonfinancial sectors, the inclusion of funds supplied to financial sectors has little effect on the picture.

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[4] Subsequent financial adjustments by companies involved in mergers and buyouts are much less visible than initial borrowing details. Some of the initial debt may have been paid down from cash flows and sales of assets; the balance possibly has been rolled over or transformed into longer maturities as interest rates have fallen, but it nonetheless remains on corporate balance sheets.

Net financial investment by each sector of the economy is equal to the excess of its saving over its outlays. Total net supplies of funds to credit markets thus originate primarily in nonfinancial sectors because they generate the bulk of national saving.

For the most part, assets acquired by intermediaries are classified as "credit market instruments," such as loans, securities, and mortgages; thus the expansion of their balance sheets runs largely parallel to their supply of funds to credit markets. In contrast, a large share of assets of nonfinancial sectors are in the form of deposit claims on intermediaries. For instance, at the end of 1985 only 13% of financial assets of households were held directly in credit market forms.

The most striking feature of net credit market lending in the 1981-85 period is the almost five-fold rise of direct credit extensions by private domestic nonfinancial sectors in a period when overall borrowing roughly doubled (Table 3). Foreign lending also rose briskly while lending by financial institutions also moved higher during this period but proportionately less so than that by nonfinancial lenders.

## Structural Shifts in Credit Supplies

Several developments in recent years have had noticeable effects on the structure of credit market supplies. Among these are the growing packaging of mortgage loans into marketable securities and the resurgence of mutual funds as an indirect channel to credit markets. Large quantities of formerly illiquid mortgages, typically carried to maturity by depository institutions, are being converted through mortgage pools into securities, for which markets are potentially much wider.[5]

Open-end investment funds (mutual funds) are another financial sector whose operations have expanded sharply toward credit market debt in recent years. In 1970, when total fund assets were $46 billion, 85% of the total was invested in

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[5] Mortgage pools are, broadly, a form of activity, but they are treated as a financial institution in the flow of funds accounts because of their legal form as trust accounts separate from other sectors and because of the way purchasers report their holdings of these assets.

Table 3

## Net Lending in U.S. Credit Markets
(Billons of Dollars)

| Sector | 1976-80, Average | % of Total | 1981 | % of Total | 1982 | % of Total | 1983 | % of Total | 1984 | % of Total | 1985 | % of Total |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Nonfinancial sectors | $ 92 | 22.3% | $110 | 22.5% | $128 | 26.1% | $186 | 28.6% | $270 | 29.8% | $ 415 | 38.0% |
| Private domestic | 55 | 13.3 | 70 | 14.3 | 89 | 18.1 | 149 | 22.9 | 207 | 22.8 | 322 | 29.5 |
| State and local governments | 15 | 3.6 | 8 | 1.6 | 27 | 5.5 | 48 | 7.4 | 50 | 5.5 | 134 | 12.3 |
| Households | 36 | 8.7 | 48 | 9.8 | 46 | 9.4 | 74 | 11.4 | 126 | 13.9 | 185 | 16.9 |
| Nonfinancial business | 4 | 1.0 | 14 | 2.9 | 15 | 3.1 | 27 | 4.1 | 31 | 3.4 | 3 | 0.3 |
| U.S. government | 16 | 3.9 | 24 | 4.9 | 16 | 3.3 | 10 | 2.5 | 17 | 1.9 | 17 | 1.5 |
| Foreign | 21 | 5.1 | 16 | 3.3 | 23 | 4.5 | 27 | 4.1 | 46 | 5.1 | 76 | 7.0 |
| Financial sectors | 320 | 77.7 | 379 | 77.5 | 364 | 74.1 | 465 | 71.4 | 637 | 70.2 | 678 | 62.0 |
| Commercial banking | 100 | 24.2 | 102 | 20.9 | 107 | 21.8 | 136 | 20.9 | 182 | 20.1 | 197 | 18.0 |
| Thrift institutions | 66 | 16.0 | 28 | 5.7 | 30 | 6.1 | 140 | 21.5 | 146 | 16.1 | 86 | 7.9 |
| Federally related mortgage pools | 17 | 4.1 | 15 | 3.1 | 50 | 10.2 | 66 | 10.1 | 44 | 4.9 | 80 | 7.3 |
| Mutual funds | 2 | 0.5 | 5 | 1.0 | 13 | 2.6 | 15 | 2.3 | 26 | 2.9 | 90 | 8.2 |
| Other | 135 | 32.8 | 229 | 46.8 | 164 | 33.4 | 108 | 16.6 | 239 | 26.4 | 225 | 20.6 |
| Total | $412 | 100.0% | $489 | 100.0% | $491 | 100.0% | $651 | 100.0% | $907 | 100.0% | $1,093 | 100.0% |
| Percent of total lending: | | | | | | | | | | | | |
| Domestic nonfinancial sectors | | 17.2% | | 19.2% | | 21.4% | | 24.4% | | 24.7% | | 31.0% |
| Foreign | | 5.1 | | 3.3 | | 4.5 | | 4.1 | | 5.1 | | 7.0 |
| Financial sectors | | 77.7 | | 77.5 | | 74.1 | | 71.4 | | 70.2 | | 62.0 |

corporate equities. Between 1981 and 1985, net investment soared $196 billion, of which $148 billion was directed into instruments such as taxable and tax-exempt bonds, with the remainder going to equities. At the end of 1985, about 47% of mutual fund assets were in credit market instruments, even after substantial increases in the value of their equity holdings.

Money market mutual funds are another example of indirect flows between households and credit markets. In the 1981-85 period, assets of these funds rose $133 billion, more than 75% of which went into short-term credit market instruments. The effect is much the same as with other mutual funds, underscoring the link between financial surpluses of households and expansion of certain financial intermediaries.

## Financial Accounts of Nonfinancial Corporations

As discussed earlier, stock retirements have been a major force behind the expansion of corporate borrowing well in excess of the financing gap during the past few years. One consequence of this has been a marked increase in corporate debt-equity ratios. If tangible assets are valued at current prices, the ratio rose from 35% in 1980 to more than 46% at the end of 1985, the highest figure since the early 1970s.

As interest rates declined sharply in 1985, corporations rapidly increased their activity in the bond markets. Net issuance of taxable bonds for the year totaled $73 billion, more than during the previous two years combined; this trend has continued even faster through mid-1986. Although much of the recent surge in corporate bonds has been associated with calls and retirements of existing debt (especially by utilities), net bond issuance continued at unprecedented levels through the first half of this year, and only 40% of funds borrowed have been in short-term markets. The effect of the resurgence of long-term borrowing has been to lower the cost of existing corporate debt and to push up the long-term debt ratio a little by the end of 1985 and somewhat more this year. However, the share of liquid assets relative to short-term debt on corporate balance sheets has declined for more than two decades and was only about 40% of such debt in 1985.

## Households

The household sector in the flow of funds and the national income accounts consists primarily of ordinary households but also includes personal trust and nonprofit organizations. Households are the largest sector in the economy, with about 41% of all financial assets at the end of 1985 (Table 4). Taking into account their holdings of tangible assets, households also have the largest net worth of any economic sector.

Households are the principal source of net savings in the economy; they typically invest much more in financial assets than they borrow, thereby making funds available to other sectors, which tend to be net absorbers of funds. Household financial surpluses directly and indirectly support the major part of net funds absorbed by other nonfinancial sectors such as businesses and governments. Remaining imbalances have been filled to a small extent by net surpluses of financial sectors and, to an increasing extent, by the foreign capital inflow associated with the U.S. external imbalance.

Household purchases of financial assets have exceeded personal saving by margins of $150 to $250 billion per year in each of the last five years, underscoring the important role played by borrowing in financing these acquisitions. Indeed, as noted earlier, household debt reached a historical high of $2.4 trillion at the end of 1985, a 64% increase in five years. Consumer credit has expanded by 77% in the last five years (to $666 billion at year-end 1985). Although the expansion of consumer credit often follows cyclical patterns, the past five years have witnessed the fastest growth in the past 40 years.

Table 4

Financial Assets in the U.S. Economy

| Sector | 1975 | 1980 | 1985 | 1975 | 1980 | 1985 |
|---|---|---|---|---|---|---|
| | $ Billions, year-end | | | Percent | | |
| Households | 2,541 | 4,498 | 7,723 | 42.1 | 41.4 | 41.4 |
| Nonfinancial business | 617 | 1,083 | 1,504 | 10.2 | 10.0 | 8.1 |
| Private financial sectors | 2,156 | 3,886 | 6,810 | 35.7 | 35.8 | 36.5 |
| Commercial banking | 835 | 1,390 | 2,234 | 13.8 | 12.8 | 12.0 |
| Mutual funds and money market mutual funds | 47 | 138 | 504 | 0.8 | 1.3 | 2.7 |
| Other[1] | 1,274 | 2,359 | 4,072 | 21.1 | 21.7 | 21.8 |
| Federally related mortgage pools | 29 | 114 | 369 | 0.5 | 1.0 | 2.0 |
| Foreign | 235 | 464 | 813 | 3.9 | 4.3 | 4.4 |
| Other[2] | 460 | 807 | 1,439 | 7.6 | 7.4 | 7.7 |
| Total | 6,038 | 10,852 | 18,658 | 100.0 | 100.0 | 100.0 |

[1] Savings institutions, insurance companies, private pension funds, state and local government retirement funds, finance companies, real estate investment trusts, and securities brokers and dealers.

[2] Federal and state and local governments, monetary authority, and sponsored credit agencies.

The ratios of debts and financial assets to disposable income have climbed noticeably in the past few years. The ratio of household debt to disposable personal income, for instance, reached a postwar high of almost 84% at the end of 1985.

Total financial assets of households rose from $4.5 trillion at the end of 1980 to $7.7 trillion at the end of 1985, an increase of about 72% during the interval. About 60% of these assets are concentrated in deposits (including shares in money market funds) and holdings of equities (including mutual fund shares) (Table 5). Three factors contribute to changes in the value of household financial assets: saving, borrowing, and market valuation. Total personal savings in the 1981-85 period represented less than 25% of the rise in the value of household portfolios, and net credit market borrowing by households was less than 30% of the increase. Market

Table 5

Structure of Household Balance Sheets
(Percent of total)

| Category | 1975 | 1980 | 1985 | Billions of Dollars, 1985 |
|---|---|---|---|---|
| **Financial assets** | | | | |
| Deposits | 37.0 | 36.0 | 34.6 | 2,675 |
| Equities (including mutual funds) | 25.5 | 26.4 | 25.2 | 1,945 |
| Credit market instruments | 13.3 | 11.7 | 13.0 | 1,005 |
| Pension fund reserves | 16.0 | 19.1 | 22.2 | 1,716 |
| Other | 8.2 | 6.8 | 4.9 | 381 |
| Total | 100.0 | 100.0 | 100.0 | 7,723 |
| **Credit market debt** | | | | |
| Home mortgages | 64.0 | 65.1 | 61.4 | 1,456 |
| Consumer credit | 30.4 | 15.9 | 28.1 | 666 |
| Other | 5.6 | 9.0 | 10.5 | 249 |
| Total | 100.0 | 100.0 | 100.0 | 2,372 |

valuation therefore plays a significant and sometimes dominant role in changes in the value of household financial positions. More than half of the $1.1 trillion increase in total household financial assets in 1985 alone can be attributed to changes in market valuation; personal saving represented less than one-eighth of this gain in wealth.

## The Role of Foreign Funds[6]

In recent years, foreign capital has played an increasing role in the supply of funds to U.S. credit markets. Any imbalance between domestic saving and investment has as its counterpart a net capital flow with the rest of the world. In effect, the "foreign sector" provides the saving (net capital inflow) needed when there is a domestic shortfall relative to investment, or absorbs such saving when there is an excess.

Net foreign investment is an overall balance, capturing measured inward and outward flows of both U.S. and foreign-owned capital, as well as components that have not been measured directly (the statistical discrepancy). The rise in the total net capital inflow corresponding to the fall in the U.S. international investment position is striking. Direct and indirect foreign support of nonfinancial borrowing reached almost 13% of credit flows in 1985, up from negative values only a few years earlier.

Focusing on components making up the international investment position of the U.S., the U.S. swung into a negative net position in 1985 for the first time since recorded statistics were begun in 1919 (See Table 6). Foreign assets in the U.S. outweighed U.S. assets abroad by $107.4 billion. The international investment position of the U.S. had been sliding toward the negative in recent years after peaking at $140.7 billion in 1981. In other words, foreign investment in U.S. assets has been outrunning the pace of U.S. investment in foreign assets in the 1980s. Both an acceleration of foreign capital inflows into the U.S. securities markets and the sharper price gains of U.S. assets than foreign assets contributed to the position of the U.S. as a "net importer of capital in 1985."

### U.S. Assets Abroad

While direct investment abroad was the largest component of the U.S. international position in the 1970s, the 1980s witnessed a dramatic escalation of bank lending to foreigners. After increasing by about $100 billion in 1981 and 1982, bank

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[6] This section, unless otherwise noted, is based largely on data and information contained in "The International Investment Position of the United States in 1985," Survey of Current Business, June 1986.

## Table 6

## International Investment Position of the United States at Yearend, 1970-85

(Billions of Dollars)

| Type of investment | 1970 | 1975 | 1980r | 1981r | 1982r | 1983r | 1984r | 1985p |
|---|---|---|---|---|---|---|---|---|
| **NET INTERNATIONAL INVESTMENT POSITION OF THE U.S.** | **58.5** | **74.2** | **106.0** | **140.7** | **136.2** | **88.5** | **4.4** | **(107.4)** |
| **Total U.S. assets abroad** | **165.4** | **295.1** | **606.9** | **719.7** | **824.9** | **874.1** | **898.2** | **952.4** |
| U.S. official reserves & Government assets | 46.6 | 58.0 | 90.3 | 98.5 | 108.3 | 113.0 | 119.6 | 130.6 |
| U.S. private assets | 118.8 | 237.1 | 516.6 | 621.2 | 716.6 | 761.1 | 778.6 | 821.8 |
| Direct investment abroad | 75.5 | 124.1 | 215.4 | 228.3 | 207.8 | 207.2 | 213.0 | 232.7 |
| Foreign securities | 20.9 | 35.0 | 62.7 | 63.5 | 75.7 | 84.3 | 90.0 | 114.1 |
| Bonds | 14.3 | 25.3 | 43.5 | 45.8 | 56.7 | 57.7 | 62.1 | 73.4 |
| Corporate stocks | 6.6 | 9.6 | 19.2 | 17.7 | 19.0 | 26.6 | 27.9 | 40.7 |
| U.S. nonbanking claims on unaffiliated foreigners | 8.5 | 18.3 | 34.7 | 35.9 | 28.6 | 35.1 | 30.0 | 28.2 |
| U.S. bank claims, not included elsewhere | 13.8 | 59.8 | 203.9 | 293.5 | 404.6 | 434.5 | 445.6 | 446.7 |
| **Total foreign assets in the U.S.** | **106.9** | **220.9** | **500.8** | **578.0** | **688.7** | **785.6** | **893.8** | **1059.8** |
| Foreign official assets | 26.2 | 86.9 | 176.1 | 180.4 | 189.1 | 194.6 | 199.1 | 202.3 |
| Other foreign assets in the U.S. | 80.8 | 134.0 | 324.8 | 398.6 | 499.6 | 591.0 | 694.7 | 857.5 |
| Direct investment | 13.3 | 27.7 | 83.0 | 108.7 | 124.7 | 137.1 | 164.6 | 183.0 |
| Treasury securities | 1.2 | 4.2 | 16.1 | 18.5 | 25.8 | 33.9 | 58.3 | 83.8 |
| Securities other than Treasury securities | 34.8 | 45.7 | 74.1 | 75.4 | 93.6 | 114.7 | 128.6 | 207.8 |
| Corporate & other bonds | 7.6 | 10.0 | 9.5 | 10.7 | 16.8 | 17.5 | 32.7 | 81.8 |
| Corporate stocks | 27.2 | 35.6 | 64.6 | 64.6 | 76.8 | 97.3 | 95.8 | 126.0 |
| U.S. nonbanking liabilities to unaffiliated foreigners | 8.8 | 13.9 | 30.4 | 30.6 | 27.5 | 26.9 | 31.0 | 29.1 |
| U.S. bank liabilities, not included elsewhere | 22.7 | 42.5 | 121.1 | 165.4 | 228.0 | 278.3 | 312.2 | 353.8 |

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r=Revised
p=Preliminary

Source: Survey of Current Business, June 1986.

lending abroad slowed significantly in 1983 and was virtually stagnant in 1984-85. The international debt repayment crisis as well as domestic problems led U.S. banks to sharply cut back on international lending. In addition, international demand for U.S. bank credit remained constrained by moderate economic growth and the availability of attractively priced financing alternatives in the securities markets. This curtailment of bank loan activity represents the most significant factor in the swing of the U.S. position.

U.S. portfolio holdings of foreign securities are estimated at $114.1 billion at year-end 1985, having increased some 27% from 1984 based on net purchases of $8.0 billion, price gains of $12.0 billion and currency appreciation. Of this amount, $40.7 billion represents stock holdings which enjoyed a 30% to 50% price appreciation boost given the strong performance of the major foreign markets. U.S. holdings of foreign bonds increased to $73.4 billion in 1985. Similar to stocks, price appreciation overshadowed net purchases. All told, U.S. foreign securities investment increased 82% from $62.7 billion in 1980 to year-end 1985. In contrast, foreign investment in U.S. securities other than Treasuries increased by 180% over the same period.

## Foreign Assets in the U.S.

Foreign acquisition of U.S. securities reached an unprecedented level in 1985. Other than those securities included in foreign official assets, foreign investors held about $291.6 billion of U.S. Treasuries, stocks and corporate bonds at year-end 1985. Of this total, $83.8 billion, or 29%, represents U.S. Treasury issues. Net purchases of Treasuries in 1985 by private foreigners and international organizations reached a dramatic $20.7 billion, with two-thirds of this amount bought by Japanese investors. The liberalization of Japanese restrictions of foreign holdings by institutions coupled with a sizable interest rate differential favoring U.S. issues prompted the dramatic increase in Japanese activity.

Much attention has focused on foreign accumulation of Treasuries. However, put into perspective as a proportion of Treasury debt, foreign holdings have actually declined, given the rapid growth of the debt itself. At midyear 1985, foreign holdings of Treasury debt stood at 11.3%, the lowest since 1971 and down from a peak of 17.5% in 1978.[7] Also contributing to the lowered proportion was the slowdown in acquisition by foreign official institutions as central banks adopted a policy of limited intervention in foreign exchange markets. Nevertheless, while foreign official holdings were declining, foreign private demand increased from 14% of total foreign Treasury holdings in 1981 to 35% as of September 1985.[8]

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[7] "The Internationalization of Uncle Sam," Economic Perspectives, Federal Reserve Bank of Chicago, May/June 1986.

The foreign appetite for U.S. securities other than Treasuries also escalated sharply in 1985. Total stock and bond holdings jumped by 62% to $207.8 billion from $128.6 billion in 1984. While stock holdings increased 31% to $126.0 billion in 1985, foreign holdings of corporate and other bonds leaped by 1 1/2 times to $81.8 billion from $32.7 billion in 1984. Record net purchases of $50.9 billion clearly exceeded price gains of $26.8 billion.

The substantial rise in foreign bond holdings reflects a number of factors. With the removal of the U.S. foreign withholding tax on interest in 1984, many companies started to raise funds directly in foreign markets. Thus, previous intercompany flows began to be captured in the securities component of the international position. In addition, comparably high U.S. interest rates coupled with the elimination of the withholding tax helped spur foreign demand for U.S. bonds.

## Summary

A review of these developments shows that special factors may have contributed to exceptionally heavy borrowing during the 1981-85 period. Although the underlying pace of borrowing appears to be slowing, growth of debt still exceeds that of GNP by a considerable margin. The heavy credit demands have been met through shifts in the structure of the supply of funds, by the more active role played by financial transformations such as mortgage pools and mutual funds, and, notably, by the net inflows of foreign saving. Any adjustment of the external accounts toward equilibrium and the corresponding fall in the supply of foreign saving will be a significant factor in domestic credit markets in the period ahead.

Jeffrey M. Schaefer
Senior Vice President and
Director of Research

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[8] *Ibid*

VOLUME

| | JULY 1986 | JAN - JLY 1986 | JULY 1985 | JAN - JLY 1985 | % CHAN. J-JL 1986-1985 |
|---|---|---|---|---|---|
| AVERAGE DAILY SHARE VOLUME ON | | | | | |
| NYSE (MILS.)* | 137.7 | 140.4 | 112.0 | 108.4 | 29.6% |
| AMEX (MILS.)* | 10.3 | 12.8 | 7.3 | 8.2 | 56.4% |
| NASDAQ (MILS.)* | 110.7 | 119.9 | 72.4 | 78.6 | 52.6% |
| REGIONAL EXCHANGE (MILS.)* | 22.6 | 23.4 | 18.1 | 18.7 | 25.0% |
| DOLLAR VALUE OF SHARES TRADED ON | | | | | |
| NYSE (MILS.) | $118,057 | $794,553 | $88,134 | $561,107 | 41.6% |
| AMEX (MILS.) | 3,671 | 26,342 | 2,168 | 14,964 | 76.0% |
| ODD-LOT SHARES PURCHASED ON NYSE (THOUS.) | 9,143 | 65,074 | 7,393 | 48,942 | 33.0% |
| ODD-LOT SHARES SOLD (INCLUDING SHORT SALES) ON NYSE (THOUS.) | 17,422 | 129,095 | 15,600 | 109,993 | 17.4% |
| NYSE BLOCK VOLUME AS A PERCENT OF TOTAL SHARES TRADED | 49.6% | 49.4% | 53.3% | 51.8% | ---- |
| CONTRACTS TRADED (THOUS.) | | | | | |
| CBOE OPTIONS | 16,050 | 109,671 | 11,617 | 82,302 | 33.3% |
| AMEX OPTIONS | 5,806 | 29,958 | 3,128 | 19,714 | 52.0% |
| COMMODITY | 15,080 | 110,859 | 13,866 | 92,266 | 20.2% |

*MONTHLY AVERAGE

## YIELDS

(MONTHLY AVERAGES)

| | AUGUST 1986 | AUGUST 1985 | BASIS POINT CHG 1986-1985 |
|---|---|---|---|
| BOND BUYER INDEX (20 BOND) | 7.21% | 9.08% | (187) |
| CORPORATE BOND YIELDS (MOODY'S) | | | |
| Aaa CORPORATE | 8.72 | 11.05 | (233) |
| Baa CORPORATE | 10.18 | 12.50 | (232) |
| RATIO Aaa CORPS. TO Baa CORPS. | 0.86 | 0.88 | (2) |
| MUNICIPAL BOND YIELDS (MOODY'S) | 7.21 | 9.08 | (187) |

## PRICES

(END OF MONTH)

| | AUGUST 1986 | AUGUST 1985 | % CHAN. Y-T-D 1986-1985 |
|---|---|---|---|
| DOW JONES INDUSTRIALS | 1898.34 | 1334.01 | 42.30% |
| STANDARD & POOR'S 500 | 252.93 | 188.63 | 34.09% |
| NYSE COMPOSITE | 145.32 | 109.39 | 32.85% |
| AMEX MARKET VALUE INDEX | 273.85 | 235.25 | 16.41% |
| VALUE LINE COMPOSITE | 236.37 | 199.91 | 18.24% |
| NASDAQ COMPOSITE | 382.86 | 297.71 | 28.60% |

## UNDERWRITING

| | JULY 1986 | JULY 1985 | % Change 1986-1985 |
|---|---|---|---|
| CORPORATE FINANCING (Gross New Issues - $ Mils) | | | |
| TOTAL | $20,134.2 | $13,138.9 | 53.2% |
| Common Stock | $2,804.1 | $2,633.0 | 6.5% |
| # of Common Stock Issues | 121 | 63 | 92.1% |
| Preferred Stock | $1,163.4 | $1,108.5 | 5.0% |
| # of Preferred Stock Issues | 19 | 13 | 46.2% |
| Corporate Debt | $16,166.7 | $9,397.4 | 72.0% |
| # of Corporate Debt Issues | 188 | 110 | 70.9% |
| MUNICIPAL FINANCING (Gross New Issues - $ Mils) | | | |
| Notes | $4,890.9 | $5,128.7 | -4.6% |
| Bonds | $20,394.6 | $13,086.3 | 55.8% |

Source: IDD Information Services and Bond Buyer

MARGIN DEBT

| | AUGUST 1986 | AUGUST 1985 | % CHANGE 1986-1985 |
|---|---|---|---|
| MARGIN DEBT OUTSTANDING ($MILS) | 33,170 | 25,780 | 28.7% |
| NET CHANGE IN MARGIN DEBT ($MILS) | 7,950 | 2,970 | 167.7% |
| % OF ACCOUNTS WITH EQUITY UNDER 40% | ----- | ----- | ----- |

## RECENT INTERESTING READING AND STATISTICAL MATERIAL

| Item | Description | Source |
|---|---|---|
| Securities Industry Data Guide | SIA booklet detailing wheres, whats, and hows of accessing existing industry data. Covers industry areas such as underwritings, firm rankings, market data, mutual funds, employee and firm earnings, exchange figures, and more, giving the provider's address and phone as well as price. First comprehensive guide published to obtaining securities industry facts and data. | SIA<br>Publications Dept.<br>$5.00 |
| Report on Branch Manager Earnings in 1985 | SIA's 65-page study based on input from 27 SIA member firms reporting on over 1,700 branch managers. In addition to information on the methods of compensating branch managers, this report presents data on profit margins, bonus practices, and earning levels broken down by state and by major metropolitan area. | SIA<br>Surveys Department<br>Participating Firms: $50<br>Member Firms: $400<br>Non-Members: $1,200 |
| "Tax Reform Pre-Game Show" | Brief examination of some of the fundamental questions that govern how corporations finance themselves and how tax reform will change the answers to those questions. Comments on capital raising, M&A, corporate structure, cash management, and the alternative minimum tax. | Investment Dealers' Digest<br>9/1/86 |
| U.S. Treasury Securities - The Market's Structure, Risks, and Regulation | First of several reports examining the operation of the government securities market. 3-main sections of the report provide general description of the government securities market, its risks, and its present regulatory structure. The appendixes give more detail on specific matters such as growth and the composition of debt, control of risk by dealers, the mechanics and use of repurchase agreements, the workings of the future and options markets and other selected topics. | U.S. General Accounting Office<br>P.O. Box 6015<br>Gaithersburg, MD 20877 |

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|---|---|---|
| "Big Bang Brief" | The "Big Bank" in London on October 27th will "blow up" restrictive practices in Britain's financial markets: fixed commission rates, demarcation lines between brokers and jobbers, and jobs in the gilts markets. The Economist is running a series of articles covering different aspects of the "Big Bang", which has included regulatory concerns, a survey of financial institutions gearing-up plans, and a review of lessons to be learned from Mayday. | The Economist<br>Start of series:<br>8/2-8 issue |
| "Hidden Risks in Portfolio Insurance" | Under portfolio insurance (PI), a pension fund manager makes a contract with a PI firm to maintain a floor, or set market value, for the fund. Stock index futures contracts are the hedging device used. Article explains how PI works and its pros and cons. | Dun's Business Month<br>September 1986 |
| "Change & the Securities Industry: More "Future Shock" in the Future?" | Highlights of the major changes in the securities industry since the early 60s and projections on the future by Peter Loeb. Concludes that the retail side of the business is doing better each year, but the capital markets area may be placing too much emphasis on short-term rather than long-term perspectives. | The Columbia Journal of World Business<br>20th Anniversary Commemorative Issue<br>Columbia University, N.Y. |
| Choosing Among Consumption Taxes | Although the Tax Reform Act of 1986 has yet to be signed into law, observers are focusing on the possibility of tax increases to reduce the federal deficit. One tax alternative that has been growing in popularity is the consumption tax. This study covers the principal features of various consumption taxes, their relative pros and cons, administrative considerations, and some key questions associated with a consumption tax. | U.S. General Accounting Office<br>P.O. Box 6015<br>Gaithersburg, MD 20877 |

10/21/86 A8825-1

Securities Industry Trends

AN ANALYSIS OF EMERGING TRENDS IN THE SECURITIES INDUSTRY
Produced by the SIA Research Department

ANNUAL SUBSCRIPTION
$48.00 member • $72.00 non-member

Vol. XII, No. 10 October 17, 1986

# The Second Quarter's Failings are Outshined by a Record First Half for the Industry and Firm Categories

## Highlights

1. Bond trading fiascos, particularly in May's long-Treasury market, drove down the industry's and (with minor exception) firm categories' revenues and profits from the first quarter's record heights.

2. Despite the quarter-to-quarter drop, the first half of 1986 witnessed two of the best half dozen quarters in industry profits ever. Also, the third quarter is now projected to join the list, most likely in the number two slot.

3. The first half's 12.7% pre-tax profit margin, if held for the entire year, will also rank in the top six years since records were kept.

4. Capital intensive business lines now dominate the industry's revenue sources and, not surprisingly, these business lines are dominated by the highest capitalized firms.

5. Together, the 10 National Full Line Firms and the 10 Large Investment Banks account for well over half of most of the industry's financial performance barometers and in some cases, such as underwriting profits, trading gains and assets, account for more than four-fifths of the industry's totals.

6. Regional firms displayed a strong start in the first half of the year with new or near record showings in such areas as profits, margins and ROEs, and were also the only firm category to avoid a second quarter profit plunge.

7. NYSE Discounters, the least capital intense category of all, were the only other group besides the Regionals to show a second quarter revenue increase and while higher costs drove profits down 13% in Q2, that fall off was less than any other group sans the Regionals.

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## THE SECURITIES INDUSTRY

In our analysis of the securities industry, SIA relies on the uniform reporting on the FOCUS form of New York Stock Exchange member firms which do a public business. These firms, though relatively few in number compared to all registered broker-dealers, account for the vast majority of the assets, capital, revenues, profits, etc., of the entire securities industry. It is for this reason, together with SIA's access to the NYSE group's quarterly financials, that this group is used as the proxy for the entire securities industry. Therefore, all references in this report to "total securities industry" refer to these NYSE reporting firms. The following tables give the reader the historical share of the NYSE firms doing a public business vs all broker-dealers listed as registered by the SEC.

### Table 1

### NYSE GROUP'S SHARE OF TOTAL INDUSTRY*
(Percent)

| Item | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 |
|---|---|---|---|---|---|---|---|
| Revenues | 80 | 80 | 81 | 81 | 80 | 81 | 77 |
| Assets | 84 | 85 | 78 | 86 | 85 | 88 | 86 |
| Capital | 66 | 65 | 66 | 70 | 72 | 71 | 70 |
| Equity | 63 | 63 | 65 | 69 | 71 | 69 | 68 |
| # of Firms | | | | | | | |
| NYSE Group | 374 | 389 | 390 | 387 | 412 | 393 | 381 |
| All Firms | 4,824 | 5,283 | 5,714 | 6,165 | 7,429 | 8,298 | 8,763 |

* Total industry based on data appearing in the SEC Monthly Statistical Review, August 1986.

The first striking fact is that the number of all firms has almost doubled over the above time span while the NYSE group remains about the same. Still, though the NYSE group is now down to about 4% of all firms from 8% in 1979, they still maintain about 80% of all revenues and 85% of assets. It is the NYSE group which handles the "core" amount of securities business and, as will be seen later in this report under concentration, the vast amount of the NYSE group's business is handled by the 10 or 25 largest firms.

## PROFIT PLUNGE LAID AT BOND TRADING'S DOOR

The securities industry experienced a 32% drop in pre-tax profits, falling from an aggregate quarterly record $1.9 billion during 1986's first three months to $1.3 billion during the second quarter.

Rising costs during the period could be branded as partly to blame, since they attributed $178 million of the $606 million fall-off in profits. But actually, expenses inched ahead only 1.6% to $11.1 billion, well below the 25% and 8% of increased costs during the previous two quarters.

Total revenue's decline of $428 million, or a 3.3% decrease, accounted for the bulk of the fall in income but the results by revenue source were unevenly distributed. The industry had a tough quarter for debt trading and a particularly rough May, especially in long Treasuries, and the income statement reflects it. Gains from trading debt securities alone fell over $1 billion, or 36%, from Q1 to Q2.

If trading activity results could have just held even with the previous quarter, the industry would have posted a new record $2.4 billion pre-tax net for the second quarter. But "would have's, could have's" are futile and even with the lower net of $1.3 billion, 1986's six month pre-tax total reached $3.2 billion...in easy striking distance of last year's 12-month record of $4.1 billion in pre-tax profits. Historically, on a quarterly nominal dollar value basis, Q2 was still one of the half dozen best quarters in pre-tax profits for the industry and followed on the heels of the best ever quarter. Preliminary results for the third quarter project about $1.7 billion in pre-tax net income, which would place it number two on the following table.

Table 2

TOP 6 QUARTERS IN PRE-TAX PROFITS

**1986 Q1 - $1.9 Billion**
1982 Q4 - $1.6 Billion
1985 Q4 - $1.5 Billion
1983 Q2 - $1.5 Billion
1983 Q1 - $1.3 Billion
**1986 Q2 - $1.3 Billion**

Aside from the radical drop-off in trading gains, Q2's revenues looked pretty healthy. Only two other major revenue categories were down, commissions and gains from investment accounts, and these were down slightly. Every other major revenue line increased over Q1.

Table 3

### TOTAL SECURITIES INDUSTRY REVENUES
(In $ Millions)

| Revenues | 1986 Q1 | 1986 Q2 | % Change |
|---|---|---|---|
| Commissions | $ 2,753.6 | $ 2,687.7 | - 2.4% |
| Gains from Trading | 3,956.5 | 2,817.8 | - 28.8 |
| Gains from Investments | 567.2 | 534.9 | - 5.7 |
| Underwriting Profits | 1,140.9 | 1,531.5 | + 34.2 |
| Margin Interest | 684.2 | 726.7 | + 6.2 |
| Mutual Fund Sales | 634.5 | 706.6 | + 11.4 |
| Fees | 272.2 | 343.7 | + 26.3 |
| Research Services | 4.8 | 10.1 | +110.4 |
| Commodities Revenues | 164.2 | 253.3 | + 54.3 |
| Other Security Related | 2,142.6 | 2,255.3 | + 5.3 |
| Other Unrelated | 495.2 | 520.4 | + 5.1 |
| TOTAL REVENUES | $12,815.6 | $12,387.5 | - 3.3% |

On the expense side, the slight rise in costs was practically across the board. Registered representative compensation increased a moderate 3%...but that increase brought RR compensation to a new quarterly record $2.3 billion, still the single largest cost other than interest expense. Interest expense was a quarterly record $3.2 billion in 1986 Q2. The increase was held to only 1%, gratis of lower interest rates helping offset the impact of record amounts of debt posted on an increasingly leveraged industry balance sheet.

Table 4

### TOTAL SECURITIES INDUSTRY EXPENSES
(In $ Millions)

| Expenses | 1986 Q1 | 1986 Q2 | % Change |
|---|---|---|---|
| RR Compensation | $ 2,230.8 | $ 2,297.2 | + 3.0% |
| Clerical/Admin. Comp. | 2,044.0 | 2,079.6 | + 1.7 |
| Partner/Officer Comp. | 355.2 | 338.5 | - 4.7 |
| Other Employee Comp. | 98.5 | 128.4 | + 30.4 |
| Floor Expenses | 412.9 | 423.2 | + 2.5 |
| Communications | 533.5 | 573.2 | + 7.4 |
| Occupancy & Equipment | 509.3 | 516.6 | + 1.4 |
| Promotional Costs | 211.7 | 252.4 | + 19.2 |
| Interest Expenses | 3,134.1 | 3,168.5 | + 1.1 |
| Losses/Errors/Bad-Debts | 109.5 | 80.4 | - 26.6 |
| EDP Costs | 145.8 | 160.9 | + 10.4 |
| Non-Recurring Charges | 4.8 | 44.7 | +831.3 |
| Regulatory Fees | 61.8 | 72.9 | + 18.0 |
| Other Expenses | 1,055.4 | 948.4 | - 10.1 |
| TOTAL EXPENSES | $10,907.3 | $11,085.1 | + 1.6% |

The only cost areas which were down in the second quarter were partner and officer remuneration; losses/error/bad-debt expenses, and "other" expenses. The $29 million reduction in the error category was more than wiped out by a $40 million increase in non-recurring charges. Communications and promotional expenses each climbed by $40 million while the biggest cost reduction in aggregate dollars, a $107 million savings, was from the anonymous "other" category, down over 10%.

## RATING RATIOS

The industry's pre-tax profit margin fell from an excellent 14.9% in the first quarter to 10.5% over the following three months. Still, for the half, the total industry's pre-tax margin was a very decent 12.7%. If that percentage held for the entire year, 1986 would be the sixth best year by this measurement since records were kept (1973) for profit margins.

Table 5

TOP 6 YEARS IN PRE-TAX PROFIT MARGINS

1976 - 14.2%
1980 - 14.1%
1975 - 13.6%
1982 - 13.1%
1983 - 12.9%
**1986 - 12.7%***

*Based on first half

The industry's pre-tax return on equity dove from 44% in the first quarter to 28% in the second. But by combining both quarters, the half's 36% ROE showing is pretty good. Still, ownership equity has increased almost four-fold since 1980, climbing from $5.4 billion to $19.2 billion as of June 30, 1986, while earnings have only about doubled. And, even with the high leveraging the industry has undertaken in recent years, it remains difficult to recreate the higher ROEs of yesteryear.

Table 6

PRE-TAX RETURN ON EQUITY

| YEAR | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 | 1986* |
|---|---|---|---|---|---|---|---|
| ROE % | 49.2 | 35.9 | 40.5 | 36.6 | 13.3 | 29.4 | 35.7 |

*Based on first half

The heavy leveraging of the industry, which accelerated greatly starting in 1984, abated somewhat this year, returning to 1984's level. As of June 30, the securities industry's assets were 22 times its equity, lower than the 24X standing at the year's onset but still a historically high leverage standing.

Table 7

LEVEL OF LEVERAGE
(Assets to Equity)

| Year | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 | 1986* |
|---|---|---|---|---|---|---|---|
| A/E | 19 | 18 | 19 | 18 | 22 | 24 | 22 |

*As of 6/30/86, all others at year-end.

## CONCENTRATION EASED, BUT BARELY

The 10 largest capitalized firms accounted for 61.4% of the industry's $25.7 billion in capital on June 30. That's down slightly from the 63.2% they accounted for six months earlier but still a high level of capital concentration. For the 11th through 25th largest firms, their share, after dipping to 14.8% last year, returned to 1983's 15.6% level, which is still relatively low. The remaining NYSE firms in the group increased their capital base at a faster clip than their 25 bigger brethren, accounting for 23% of total capital as of June 30. Still, 23% is far less than the 50% of all capital the non-25-largest firms held back in 1973 (the earliest year of record).

Table 8

CONCENTRATION: % SHARE OF CAPITAL

| Year | Top 10 | Top 11-25 | Rest |
|---|---|---|---|
| 1973 | 35.0 | 15.2 | 49.8 |
| 1974 | 40.8 | 17.2 | 42.0 |
| 1975 | 42.5 | 17.0 | 40.5 |
| 1976 | 43.8 | 17.5 | 38.7 |
| 1977 | 43.5 | 20.8 | 35.7 |
| 1978 | 44.9 | 24.0 | 31.1 |
| 1979 | 45.8 | 18.8 | 35.4 |
| 1980 | 50.8 | 18.0 | 31.2 |
| 1981 | 50.0 | 19.7 | 30.3 |
| 1982 | 54.8 | 18.3 | 26.9 |
| 1983 | 52.8 | 18.8 | 28.4 |
| 1984 | 57.2 | 15.6 | 27.2 |
| 1985 | 63.2 | 14.8 | 22.0 |
| 1986* | 61.4 | 15.6 | 23.0 |

*As of 6/30/86.

Concentration on the revenue side also dipped slightly for the top 10 capitalized firms. Having peaked in 1984's off year at 58.8% of all revenues for these firms, the level fell to 57.5% last year and then to 57.2% as of June 30. But that's still high enough to be one of the most concentrated years ever.

Table 9

CONCENTRATION: % SHARE OF REVENUE

| Year | Top 10 | Top 11-25 | Rest |
|---|---|---|---|
| 1973 | 33.6 | 14.2 | 52.2 |
| 1974 | 38.2 | 17.8 | 44.0 |
| 1975 | 40.1 | 18.0 | 41.9 |
| 1976 | 41.6 | 18.7 | 39.7 |
| 1977 | 41.4 | 21.0 | 37.6 |
| 1978 | 44.5 | 26.2 | 29.3 |
| 1979 | 48.7 | 18.6 | 32.7 |
| 1980 | 53.1 | 19.4 | 27.5 |
| 1981 | 55.6 | 18.7 | 25.7 |
| 1982 | 57.3 | 18.7 | 24.0 |
| 1983 | 54.4 | 19.6 | 26.0 |
| 1984 | 58.8 | 17.1 | 24.1 |
| 1985 | 57.5 | 19.7 | 22.8 |
| 1986* | 57.2 | 19.6 | 23.2 |

*As of 6/30/86.

The biggest factor in the large capitalized firms' success in capturing the majority of revenues is that over the years they have built up a very successful and huge money machine in capital intensive business lines. Two of the most capital intense revenue sources are trading and investments. On the opposite end of the spectrum, commissions are probably the least capital intensive revenue source. The next table shows how the capital intense revenue sources have grown in importance to total industry revenues while non-capital intense sources have declined. Both have grown in aggregate dollars, however. Trading and investment revenues have gone from a mere 8% of all industry revenues back in 1973 to nearly a third of the total today. Meanwhile, commissions have fallen from more than half of all industry revenues in 1973 to about one-fifth of the total recently.

To look at it another way, while commissions have expanded three-fold from 1973 to 1985, revenues from trading and investments have multiplied more than 27-fold!

Naturally the biggest capitalized firms generate the majority of the revenues from capital intense business lines. For the first six months of this year the ten largest capitalized firms accounted for 64% of all the industry's trading and investment revenues. For the 25 largest, the figure is an astounding 82.5%!

Table 10

BUSINESS LINE'S SHARE OF INDUSTRY REVENUES

| Year | Trading & Investments | Commissions |
|---|---|---|
| 1973 | 8.4 | 55.4 |
| 1974 | 12.8 | 49.1 |
| 1975 | 15.6 | 49.9 |
| 1976 | 20.3 | 45.8 |
| 1977 | 19.3 | 41.7 |
| 1978 | 17.5 | 42.8 |
| 1979 | 23.6 | 35.8 |
| 1980 | 23.1 | 35.4 |
| 1981 | 24.3 | 27.0 |
| 1982 | 28.2 | 25.9 |
| 1983 | 25.6 | 28.2 |
| 1984 | 26.5 | 22.7 |
| 1985 | 28.5 | 21.3 |
| 1986* | 31.3 | 21.6 |

*As of 6/30/86.

As far as the non-10 largest's share of revenues, the top 11-25 tier held pretty even with 19.6% of revenues in 1986 vs. 19.7% last year, but that's still not close to its record 26.2% back in 1978. For the rest of the industry, the slight increase from 22% last year to 23% in this year's first half is not much to celebrate over since it's the second lowest percentage showing ever. In effect, the big are getting bigger!

## RESULTS BY SIA/SEC FIRM CATEGORIES

Periodically, SIA, in conjunction with the New York Stock Exchange and the Securities & Exchange Commission, re-appraise the NYSE reporting firms in order to ensure that industry data are based on the most recent and accurate categorization. The most recent such re-appraisal was completed after a four-month study and the new classification list is attached to this report.

A couple of changes in the new classifications warrant notice. First, the "Traders & Market Makers" and "Clearing" categories, each of which had fallen to less than 10 firms apiece, have been eliminated (the firms in these categories are thus reclassified...not eliminated). Second, "Discounters" are no longer distinguished between "carrying" and "non-carrying." Finally, new revenue thresholds (which are delineated on the attached list) were needed for our "large/medium/small" break-outs due to the growth within the industry.

The reclassification better reflects the present industry make-up and, in most cases, does not affect the continuity of each firm category's year-to-year results. Both the "Large Investment Banks" and the "National Full Line" firms had no changes whatsoever.

For Regional firms, though there were some minor changes in the total group as well as new revenue cut-off points, the category remains comparable to prior years. New York City regional firms as a group were affected somewhat as were the "large/small" sub-categories, which should be kept in mind if comparing 1986 to prior years, particularly for aggregate dollar amounts. The NYSE "Discounters" after 1985 can no longer be divided into carrying and non-carrying (there had been little demand for this distinction), and also were affected to a degree where prior year comparisons become difficult in some areas, particularly aggregates.

The "Commission Introducing" category (non-carrying, non-clearing firms which file an abbreviated FOCUS form), was affected to a degree that results prior to 1986 should not be compared to current or future results! The same applies to the catch-all "Other" category.

## LARGE INVESTMENT BANKS

The 10 large investment banks took the biggest hit in debt trading losses in the second quarter. This group accounted for $638 million of the $1 billion drop in bond trading revenues from Q1 to Q2 1986. Still, thanks to a great first quarter, the six-month bond trading gains are $2.1 billion, which when annualized will still make this revenue source break $4 billion in 1986, up 40% over last year's record showing for this group and a record for any of the firm categories.

Other than trading gains, all other revenue sources for the large investment banks showed a quarter-to-quarter increase with the exception of underwriting revenues, down a mere 3.5%. Annualizing the LIB's six month results, however, shows that every major revenue line should attain record results this year.

### Table 11

### LARGE INVESTMENT BANK REVENUES
(In $ Millions)

| Revenues | 1982 | 1983 | 1984 | 1985 | 1986* |
|---|---|---|---|---|---|
| Commissions | 803 | 1,216 | 1,068 | 1,127 | 1,462 |
| Trading Gains | 2,675 | 2,708 | 3,397 | 3,876 | 5,526 |
| Debt Trading Portion | 2,095 | 2,013 | 2,702 | 3,021 | 4,204 |
| Gains from Investments | 217 | 365 | 364 | 409 | 1,041 |
| Underwriting | 560 | 1,051 | 734 | 1,377 | 1,751 |
| Margin Interest | 183 | 269 | 385 | 374 | 483 |
| TOTAL REVENUES | 6,944 | 8,209 | 10,103 | 12,098 | 15,323 |

*Annualized, based on first half.

Unlike the plunge in trading gains from quarter to quarter, the LIBs have done well in investments for their own accounts. After a great showing of $236 million net in this category for 1986 Q1, the net gain climbed to $284 million in Q2. At that pace, the LIBs will exceed last year's record $409 million gain by 155%, with a $1 billion showing. Also, commissions for the LIBs are running at an annual $1.5 billion record pace.

Meanwhile, underwriting profits should reach a record $1.8 billion this year. The $876 million in underwriting profits these 10 firms earned during the half was exactly one-third of all underwriting profits during the period. According to "IDD Information Services," these same firms lead-managed the underwritings of a third of the dollar volume of all municipal offerings during the period and 62% of the corporate underwritings. That's just over half of the dollar amount of all underwritings but since the LIBs are heavy on the corporate debt underwriting side, where margins are thinner, the profits are only one-third, not one-half, of the total industry's results.

The biggest expense item for the LIBs is interest expense. Last year, the LIBs paid a record $5.2 billion in interest and at the first half's pace, 1986's interest will cost them an additional $1 billion more, or 44% of all revenues. For the second quarter alone, interest ate up 46% of the LIBs revenues! The LIBs have been successful at using high levels of leverage to return high profit margins, but at these heady levels the risk/reward ratio could be more risk if the interest rate environment ever swings back to an early-Eighties type environment.

Next to interest, the LIBs biggest expense is people costs. All told, this year's first half showed $2 billion in this area vs a record $2.8 billion for all of last year. At that pace, payroll will jump $1 billion this year or 38%! Half of that cost goes to clerical and administrative employees and only 18% to registered representatives whereas for the industry as a whole, half goes to brokers. Of course, the LIB registered respresentative is almost exclusively an institutional broker where the payouts, in percentage terms, are half the level of the retail RR, according to SIA's "Report on Production and Earnings of RRs in 1985," an annual publication based on confidential surveys of member organizations. Conversely, the LIBs are operating with vastly fewer RRs each grossing on average five times a retail RR's production and each keeping only half the retail broker's percentage payout!

Again, even with total expenses running at a record $13.2 billion annual rate, the LIBs annual pre-tax net income this year should hit $2.1 billion, which will exceed last year's record $1.8 billion by 16%!

Table 12

LEVEL OF LEVERAGE
(Assets to Equity)

| Firm Category | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 | 1986* |
|---|---|---|---|---|---|---|---|
| Large Investment Banks | 32 | 31 | 34 | 31 | 36 | 42 | 38 |
| Total Industry | 19 | 18 | 19 | 18 | 22 | 24 | 22 |
| National Full Line | 15 | 14 | 13 | 15 | 18 | 18 | 16 |

*As of 6/30/86, all others at year-end.

The two most highly leveraged category of firms are the LIBs and the NFLs. All other categories, such as Discounters, Regionals and New York City firms, have historically had lower, in some cases, much lower leverage ratios. The LIBs super high leverage ratio, combined with the fact that they have more than half of all assets, drives the total securities industry leverage ratio higher than all firm categories except the LIBs themselves. As of mid-year, the LIBs had record assets of $225.5 billion, nearly a quarter of a trillion dollars!

The "Large" in these 10 firms' category's name is well deserved. Making up less than 3% of all the NYSE firms doing a public business, they account for huge percentages of the group's numbers and are only equaled or surpassed in some areas by one other group, the 10 National Full Line firms.

Table 13

LIB AND NFL % SHARE OF 1986 TOTAL INDUSTRY BUSINESS

| Business: | LIBs | NFLs | BOTH* |
|---|---|---|---|
| Assets | 54 | 29 | 83 |
| Capital | 33 | 41 | 74 |
| Equity | 31 | 39 | 70 |
| Pre-Tax Profits | 32 | 28 | 60 |
| Revenues | 30 | 44 | 74 |
| Expenses | 30 | 46 | 76 |
| Commission Revenues | 13 | 44 | 58 |
| Trading Gains | 41 | 41 | 82 |
| Investment Gains | 47 | 6 | 53 |
| Underwriting Profits | 33 | 50 | 82 |
| Margin Interest | 17 | 51 | 68 |
| Mutual Funds | 2 | 71 | 73 |
| RR Compensation | 16 | 60 | 76 |
| All Employee Compensation | 20 | 53 | 73 |
| Employees | 13 | 59 | 73 |

*May not add due to rounding.

As can be seen by the preceding table, in terms of market share the LIBs and the NFLs dominate the industry and their results will weigh very heavily in the aggregates of the "total" securities industry.

Even if these 20 firms are compared to the nearly 9,000 total broker dealers, where they are only 0.2% of the group, they still account for more than half of much of the securities business including assets, capital, revenues and expenses.

## NATIONAL FULL LINE FIRMS

The National Full Line firms' bond trading departments also took a beating in the second quarter. After posting revenues of $1.6 billion from trading gains in the first quarter, Q2's $1.1 billion was down 30%. The majority of both figures was from bond trading which alone fell 47% from quarter to quarter. All other revenue sources in the second quarter either held at or rose above Q1 levels. Total revenues remained even at $5.5 billion each quarter. The bottom line, however, suffered from higher costs in Q2 with pre-tax net income plunging 40% from $572 million in Q1 to $341 million in Q2. But the results of both quarters combined shows $913 million of net income already sewn-up, almost equal to last year's 12-month sum of $940 million. Annualized, net income should be $1.8 billion this year or 65% higher than 1983's record $1.1 billion for these 10 firms.

Total revenues should also climb 31% over last year to a new record $22 billion. All of the revenue components will exceed last year's results and, with the exception of margin interest, will set new records. Commissions will rise 31%, mutual fund sale revenues will be up 41%, trading gains will be up 36%, underwriting will be up 28%, but margin interest will climb only 7% to $1.4 billion, less than 1984's record $1.5 billion.

### Table 14

### NATIONAL FULL LINE REVENUES
(In $ Millions)

| Revenues | 1982 | 1983 | 1984 | 1985 | 1986* |
|---|---|---|---|---|---|
| Commissions | 2,697 | 3,629 | 2,936 | 3,524 | 4,801 |
| Trading Gains | 2,280 | 2,892 | 3,038 | 4,506 | 5,977 |
| Debt Trading Portion | 1,854 | 1,991 | 2,338 | 3,460 | 4,398 |
| Gains from Investments | 8 | 37 | 110 | 92 | 126 |
| Underwriting | 1,255 | 1,593 | 1,457 | 2,075 | 2,648 |
| Margin Interest | 1,174 | 1,201 | 1,547 | 1,357 | 1,448 |
| TOTAL REVENUES | 9,889 | 12,923 | 13,066 | 16,712 | 21,944 |

*Annualized, based on first half.

The 50% of record underwriting profits the NFLs were able to garner in the first half was all the more impressive since, according to ""IDD Information Services," these 10 firms ran the books for only a third of the dollar value of all corporate and all municipal underwritings during the same period. But the NFLs are much more equity-oriented than their LIB cousins, and that's where the larger commission spreads are.

The NFLs have also been capitalizing on the growing popularity of mutual funds, capturing $1 billion from January through June in sales of open-ended funds, exclusive of management fees. In fact, they captured 71% of all revenues from this source which the NYSE firms earned during the half. And since the household sector has been pouring their savings into mutuals since 1982, going from $90 billion or 1.7% of their total financial assets in 1982 to nearly $400 billion or 4.6% of total assets this year, the NFLs are well poised for what appears to be continued profitable growth from this sector.

While revenues are expanding to record levels, the expense side of the income statement is doing likewise. Here there is some good news and bad news...so first the bad. Expenses this year are running at a record $20 billion annual pace. That's 28% higher than last year's record $16 billion in expenses. The good...revenues' projected 31% increase this year outpaces expenses' 28% climb, leaving a hefty 94% projected increase in pre-tax net income for the NFLs.

Table 15

NATIONAL FULL LINE EXPENSES
(In $ Millions)

| Expenses | 1982 | 1983 | 1984 | 1985 | 1986* |
|---|---|---|---|---|---|
| RR Compensation | 2,452 | 3,451 | 3,246 | 4,137 | 5,434 |
| All Other Compensation | 2,088 | 2,804 | 2,921 | 3,602 | 4,700 |
| Floor Expenses | 308 | 362 | 347 | 374 | 446 |
| Communications | 767 | 923 | 1,066 | 1,157 | 1,310 |
| Occupancy & Equipment | 473 | 630 | 861 | 1,068 | 1,163 |
| Promotional Costs | 325 | 468 | 457 | 500 | 539 |
| EDP Expenses | 139 | 148 | 197 | 182 | 221 |
| Interest Expenses | 1,466 | 1,757 | 2,822 | 3,187 | 4,139 |
| TOTAL EXPENSES | 9,018 | 11,814 | 13,184 | 15 773 | 20,118 |

*Annualized, based on first half.

RR compensation is still the number one expense for the National Full Line firms, eating up a quarter of all revenues so far this year. When you add in all other compensation (clerical, administration, bonuses, officer and partner compensation, etc.) nearly half of the NFLs revenues are already spoken for. This compares to just one-quarter of all revenues going for people costs at the Large Investment Banks. But the LIBs are operating mainly in the capital intensive, high return (with corresponding high risk) business areas with revenues per employee about four times that of the NFLs and profits per employee about ten times the NFL's. And, as seen before, the branch network, retail oriented NFLs are operating in an environment as such that they employ five times the number of employees as the LIBs and their retail RRs, the bulk of their broker force, receive double the percentage payout of the institutional RR (virtually the only sales force of the LIBs).

The next biggest expense is interest costs which should break $4 billion this year based on the first half's results. Though this eats up a smaller percent of all revenues than the LIBs, 19% vs 44%, it still has a big enough impact on the bottom line that the NFLs' leveraged balance sheet is also vulnerable should the early 80s rate environment resurface.

It is these two costs, payroll and interest, which are increasing at a very fast clip. Each are projected to increase about 30% this year. Together these costs represented 71% of all NFL expenses this year.

The NFLs have had more success in holding down cost increases in other areas. Based on first half results, communication costs will rise only 13% this year and occupancy and equipment cost increases should be under 9%. Promotional spending is running less than 8% ahead of last year's rate and though floor costs and data processing expenses are headed toward 20% increases, that's a lot less than the 30% increases in people and interest expenses.

The NFLs have also been able to improve their margins this year. Their pre-tax profit margins, return on equity, their share of industry revenues and profits have all increased to the best levels since 1983 (see following Tables 16, 17, 20 and 21). The bottom line is the bottom line...NFL's pre-tax net income is projected to reach a record $1.8 billion this year.

## REGIONAL FIRMS

On June 30th of this year, there were 94 non-New-York-based Regional firms out of the 364 New York Stock Exchange firms doing a public business, or 26% of the total. This group has for 2 1/2 years accounted for 10% of the NYSE firms' revenues. This is lower than the 14% they had in 1980-81 or the 12% in 1982-83.

Table 16

FIRM CATEGORY'S % SHARE OF REVENUES

| Firms | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 | 1986* |
|---|---|---|---|---|---|---|---|
| **Regionals** | **14** | **14** | **12** | **12** | **10** | **10** | **10** |
| National Full Line | 46 | 42 | 43 | 44 | 42 | 43 | 44 |
| Large Investment Banks | 23 | 29 | 30 | 28 | 32 | 31 | 30 |

*For first half

This does not mean that Regional firms' revenues have been decreasing, in fact this year Regionals should out-do last year's record revenues. It does mean, however, that other firms are increasing their revenues faster than the Regionals. In this case it is the 10 Large Investment Banks which as a group have increased their share of industry revenues from 23% in 1980 to 30% this year.

At the bottom line, the picture is a little better. Regionals' share of pre-tax profits this year is at least back to matching their share of revenues, now 10%. In 1984, though Regionals captured 10% of revenues, they captured only 5% of profits.

Table 17

FIRM CATEGORY'S % SHARE OF PRE-TAX PROFITS

| Firms | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 | 1986* |
|---|---|---|---|---|---|---|---|
| **Regionals** | **15** | **14** | **10** | **12** | **5** | **9** | **10** |
| National Full Line | 35 | 27 | 29 | 29 | (7) | 23 | 28 |
| Large Investment Banks | 29 | 41 | 40 | 36 | 72 | 43 | 32 |

*For first half

As far as total profits of Regionals are concerned, this year should exceed 1983's record pre-tax net of $458 million and, as will be discussed a little later, their return on equity is at record levels also.

## THIS YEAR'S QUARTERS

For the Regional firms, 1986's second quarter didn't look much different than the first. But that's good since both were outstanding quarters and have assured a record-breaking year for these firms as a whole. Revenues were up 3.6% in the second quarter for Regionals while the industry as a whole showed a 3.3% decline. Profits were flat from quarter to quarter at about $160 million each. Annualized, that will give the Regionals a $640 million pre-tax profit this year, 40% higher than the previous record $458 million back in 1983. The fact that Regional firms in the second quarter were able to maintain their revenue and profit levels at first quarter levels is impressive since they were the only firm category to do so (though the NYSE Discounters did so for just revenues).

And though total revenues were about even, $1.2 billion in Q1 vs $1.3 billion in Q2, the sources of revenue showed some ups and downs. Underwriting revenue was up a healthy 41% and is running at such a pace that it should exceed both 1983's and 1985's record levels. On the other hand, trading gains fell 14% in the second quarter, from $261 million to $226 million, but that's not so bad considering these gains fell 29% for the industry as a whole and are still running at an annualized $1 billion pace for Regionals, which would be a new yearly record. Mutual fund revenues also were up 15%, mirroring the explosion in these sales throughout all retail firms, and should finish the year at double last year's record amount.

Table 18

REVENUES OF REGIONAL FIRMS
(In $ Millions)

| Revenues | 1986 Q1 | 1986 Q2 | % Change |
|---|---|---|---|
| Commissions | $ 442.1 | $ 424.7 | - 4% |
| Trading Gains | 260.9 | 225.8 | - 14 |
| Gains from Investments | 20.9 | 15.9 | - 24 |
| Underwriting Profits | 133.8 | 188.2 | + 41 |
| Margin Interest | 68.9 | 67.8 | - 2 |
| Mutual Fund Sales | 150.7 | 172.7 | + 15 |
| Fee Income | 17.5 | 20.3 | + 16 |
| Research | 2.3 | 3.3 | + 44 |
| Commodities | 10.9 | 13.4 | + 23 |
| Other Securities Related | 95.6 | 120.7 | + 26 |
| Other | 27.8 | 23.4 | - 16 |
| TOTAL REVENUES | $1,231.3 | $1,276.2 | + 4% |
| PRE-TAX PROFITS | $ 160.9 | $ 159.4 | - 1% |

## RELATIVE IMPORTANCE OF REVENUE SOURCES

Though in aggregate, most revenue sources for Regionals are headed to record levels this year, some source's contribution to the bottom line have increased in importance over the years while others have decreased. Commissions have always been the number one source of revenues for Regional firms and still are today. However, in recent years, commissions have hovered at just over a third of all Regional revenues while six years ago it was closer to half. The decreasing importance of commissions for Regionals is not as drastic as it has been for the total industry which over the same time span has seen commissions' share fall to one-fifth of all revenue. Trading gains have slowly increased to 19% of Regional's revenues while for the entire industry, trading has become the number one revenue source providing over a quarter of all industry revenues.

Regional firms have more than matched the industry's growth in mutual fund sales revenues. These sales provided 13% of Regionals' revenues for this year's first half compared to less than 2% five years ago. Underwriting remains a steady stream of income for Regionals despite the drastic reduction in size of syndicates, the large number of deals not even syndicated and the dominance of corporate underwritings, particularly bonds, by several large New York firms.

### Table 19

### PERCENTAGE SHARE OF TOTAL REVENUES

Regional Firms

| Revenues | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 | 1986* |
|---|---|---|---|---|---|---|---|
| Commissions | 46 | 36 | 37 | 39 | 36 | 34 | 35 |
| Trading Gains | 14 | 15 | 18 | 16 | 16 | 18 | 19 |
| Investments | 1 | 1 | 2 | 1 | 1 | 1 | 2 |
| Underwriting | 11 | 12 | 13 | 17 | 12 | 15 | 13 |
| Margin Interest | 14 | 19 | 11 | 9 | 12 | 7 | 6 |
| Mutual Fund Sales | 2 | 2 | 2 | 4 | 5 | 9 | 13 |

Total Industry

| Revenues | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 | 1986* |
|---|---|---|---|---|---|---|---|
| Commissions | 35 | 27 | 26 | 28 | 23 | 21 | 22 |
| Trading Gains | 20 | 21 | 26 | 23 | 24 | 26 | 27 |
| Investments | 4 | 3 | 3 | 3 | 2 | 3 | 4 |
| Underwriting | 8 | 8 | 10 | 12 | 9 | 11 | 11 |
| Margin Interest | 13 | 15 | 9 | 7 | 9 | 7 | 6 |
| Mutual Fund Sales | 1 | 1 | 1 | 3 | 2 | 4 | 5 |

*For first half

## REGIONAL'S RATIOS

For the first time in five years, Regional firms' profit margins have climbed above the industry average, although just barely. For the first six months of this year, Regionals had a 12.8% pre-tax margin vs 12.7% for the industry. It was also higher than any full-year margin for the Regionals since 1980's 14.7% showing.

Table 20

PRE-TAX PROFIT MARGINS
(In Percent)

| Firm Category | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 | 1986* |
|---|---|---|---|---|---|---|---|
| **Regionals** | **14.7** | **11.2** | **11.1** | **12.6** | **2.6** | **9.4** | **12.8** |
| National Full Line | 10.9 | 6.9 | 8.8 | 8.6 | (0.9) | 5.6 | 8.3 |
| Large Investment Banks | 17.7 | 15.4 | 17.4 | 16.7 | 11.4 | 14.6 | 13.4 |
| Total Industry | 14.1 | 10.8 | 13.1 | 12.9 | 5.2 | 10.7 | 12.7 |

*For first half

Regional's pre-tax return on equity has climbed way back up since 1984's poor showing of 6.8%. It now exceeds that of the LIBs, the NFLs and the industry as a whole. That's even more impressive when you consider that the Regionals' returns are measured against an equity base that is 15.4% of their total assets vs 6.3% for the NFLs, 2.5% for the LIBs or 4.6% for the total industry! Of course the Regionals operate in a much less capital intense environment than the NFLs or LIBs, with, for example, 35% of their revenues coming from the non-capital necessary source, commissions.

Table 21

PRE-TAX ROE

| Firm Category | 1981 | 1982 | 1983 | 1984 | 1985 | 1986* |
|---|---|---|---|---|---|---|
| **Regionals** | **37.2** | **36.0** | **40.5** | **6.8** | **29.0** | **40.7** |
| National Full Line | 24.6 | 29.8 | 28.1 | (2.6) | 17.9 | 25.9 |
| Large Investment Banks | 56.7 | 54.8 | 43.8 | 31.1 | 38.5 | 36.9 |
| Total Industry | 35.9 | 40.5 | 36.6 | 13.3 | 29.4 | 35.7 |

*For first half

Though Regionals have lost some industry footing in some areas while gaining in others, the big picture is this group will show an impressive 69% year-to-year increase in profitability to a record $641 million in pre-tax net income.

## NEW YORK CITY-BASED REGIONALS

The quarter to quarter picture for the New York City-Based Regional firms pretty much mirrored the results of the other firm categories as well as the total industry. Trading gains dropped sharply in the second quarter as did realized and unrealized gains from these firms' own investment accounts. Underwriting profits were up sharply while commission revenues and mutual fund sale revenues were flat, but flat at nice levels. Total revenues dropped 7%, mainly from the bond market environment during the second quarter.

### Table 22

### NEW YORK CITY-BASED REGIONAL'S INCOME STATEMENT
(In $ Millions)

| Revenues | 1986 Q1 | 1986 Q2 | % Change |
|---|---|---|---|
| Commissions | $ 334.4 | $ 332.7 | - 1% |
| Trading Gains | 229.8 | 180.9 | - 21 |
| Gains from Investments | 80.2 | 51.1 | - 36 |
| Underwriting Profits | 33.7 | 51.9 | + 54 |
| Margin Interest | 43.3 | 40.3 | - 7 |
| Mutual Fund Sales | 13.0 | 13.1 | + 1 |
| Fee Income | 55.8 | 60.5 | + 8 |
| TOTAL REVENUES | $1,018.9 | $ 947.0 | - 7% |
| **Expenses** | | | |
| RR Compensation | $ 131.2 | $ 114.8 | - 13% |
| All Other Compensation | 221.2 | 246.0 | + 11 |
| Floor Expenses | 64.0 | 60.2 | - 6 |
| Communications | 31.3 | 29.1 | - 7 |
| Occupancy & Equipment | 32.5 | 33.0 | + 2 |
| Promotional Costs | 14.9 | 15.0 | + 1 |
| Interest Expense | 154.3 | 177.2 | + 15 |
| TOTAL EXPENSES | $ 765.7 | $ 795.8 | + 4% |
| PRE-TAX PROFITS | $ 253.2 | $ 151.2 | - 40% |

Expenses climbed a total of 4% but not across the board. Broker compensation actually fell 13% in the second quarter but the savings was more than wiped out by other employee, including officer and partner remuneration, pay-outs. The 15% increase in interest expense almost made up the entire $30 million cost increase for the NYCs in 1986 Q2. Combining the 7% drop in revenues with the 4% cost increases summed up to a 40% drop in profitability for the NYCs in 1986 Q2.

The NYCs' ROE for the first half is hovering around 50%, about matching their best years. This was accomplished, however, on a leveraged balance sheet with their assets to equity matching the NFLs at 16 times equity, up from 14 times last year. The NYCs' pre-tax profit margin, meanwhile, was slashed from 24.9% to 16.0%.

## DISCOUNTERS

On a quarter to quarter basis in this year's first half, the NYSE-member Discounters maintained their excellent first quarter results better than any other group except the Regional firms. Other than the 1% decline in profits for the Regionals, the Discounters 13% profit decline was mild compared to the 30%-to-40+% drops for other groups.

### Table 23

### 1986 Q2 VS Q1 PROFIT PLUNGE

| | |
|---|---|
| Regionals | - 1% |
| **Discounters** | **- 13%** |
| Large Investment Banks | - 28% |
| Total Industry | - 32% |
| All Other Firms | - 32% |
| National Full Line | - 40% |
| New York City-Based | - 40% |
| Commission Introducing | - 43% |

The decline in profits was entirely due to increased costs for the Discounters since they, as well as the Regional firms, managed to increase their second quarter revenues. The two principal product lines for Discounters, commissions making up 60% of revenues and margin making up an additional 16%, were both up in the second quarter. This brought total revenues up 3% to $229 million in the second quarter and Discounters should finish the year with a record $900 million in revenues.

### Table 24

### NYSE DISCOUNTER'S INCOME STATEMENT
(In $ Millions)

| Revenues | 1986 Q1 | 1986 Q2 | % Change |
|---|---|---|---|
| Commissions | $133.9 | $137.8 | + 3% |
| Trading Gains | 2.5 | 2.3 | - 8 |
| Gains from Investments | 5.7 | 3.3 | - 43 |
| Margin Interest | 34.8 | 37.8 | + 9 |
| TOTAL REVENUES | $223.0 | $228.7 | + 3% |
| **Expenses** | | | |
| RR Compensation | $ 5.4 | $ 5.9 | + 9% |
| All Other Compensation | 42.2 | 45.8 | + 9 |
| Floor Expenses | 37.6 | 35.9 | - 5 |
| Communications | 10.0 | 11.4 | + 14 |
| Occupancy & Equipment | 9.3 | 9.9 | + 6 |
| Promotional Costs | 6.6 | 4.8 | - 27 |
| Interest Expense | 29.9 | 29.9 | NC |
| EDP costs | 10.9 | 10.6 | - 3 |
| TOTAL EXPENSES | $180.2 | $191.4 | + 6% |
| PRE-TAX PROFITS | $ 42.8 | $ 37.3 | - 13% |

Still, the revenue gains were more than offset by higher costs in Q2. Expenses increased at twice the pace of revenue gains, 6% or $11.2 million, leaving pre-tax net for Q2 down 13% to $37.3 million.

As stated earlier, the total industry and all firm categories are analyzed using those firms in each category which are members of the New York Stock Exchange and are doing a public business. And as shown, these firms are representing the vast majority of the securities business. However, for Discounters, which like other categories also have several firms with a large concentration of their particular market, their has been demonstrated a very high interest for SIA to provide additional financial information beyond just the NYSE group.

To that end, SIA is currently compiling a comprehensive list of discount brokers in the U.S. in order to attempt to obtain as much additional financial data as possible on discounters beyond the NYSE group for future analysis and publication (hopefully soon).

## COMMISSION INTRODUCING FIRMS

The Commission Introducing firms, broker-dealers which do not clear or carry their own customer accounts and thus file an abbreviated FOCUS Part IIA short form, showed the biggest percentage drop in earnings of any firm category...43%. Even though these firms managed to hold expenses even from quarter to quarter, reduced commissions and trading and investment gains, their principal business, caused the entire downturn.

### Table 25

### COMMISSION INTRODUCING FIRMS' INCOME STATEMENT
(In $ Millions)

| Revenues | 1986 Q1 | 1986 Q2 | % Change |
|---|---|---|---|
| Commissions | $106.7 | $ 97.5 | - 9% |
| Trading Gains | 24.0 | 20.8 | - 13 |
| Gains from Investments | 21.2 | 8.1 | - 62 |
| Underwriting | 5.8 | 6.5 | + 12 |
| Fees | 13.2 | 13.6 | + 3 |
| TOTAL REVENUES | $196.2 | $167.5 | - 15% |
| **Expenses** | | | |
| Employee Compensation | $ 45.8 | $ 51.0 | + 11% |
| Floor Expenses | 18.5 | 17.0 | - 8 |
| Interest Expense | 4.4 | 3.9 | - 11 |
| TOTAL EXPENSES | $128.7 | $128.9 | NC |
| PRE-TAX PROFITS | $ 67.5 | $ 38.6 | - 43% |

## ALL OTHER FIRMS

The remaining non-categorized firms also showed a steep earnings drop, 32%, from 1986 Q1 to Q2. Revenues fell from $675 million to $607 million, again mainly from big drops in trading and investment gains, while expenses held even at $460 million per quarter.

## CONCLUSION

The bond market problems this Spring caused an across the board reduction in second quarter earnings relative to the first quarter. Most other business lines for most firms showed improvements, sometimes very healthy improvements.

The six month results are of such a historically high magnitude that barring an unforeseen disaster, 1986 is guaranteed a place in the record books for revenues, profits and gains in most, if not all, business lines.

As of this writing, preliminary FOCUS results from 15 of the largest firms indicate third quarter revenues will hit new highs for the industry of around $13 billion and pre-tax profits falling in the $1.7 billion neighborhood. If the final figures for Q3 match the projections, the annualized figures throughout this report, which project numerous record breaking results, will actually prove a bit on the conservative side!

George R. Monahan
Assistant Director
of Research

## VOLUME

| | JULY 1986 | JAN - JLY 1986 | JULY 1985 | JAN - JLY 1985 | % CHAN. J-JL 1986-1985 |
|---|---|---|---|---|---|
| AVERAGE DAILY SHARE VOLUME ON | | | | | |
| NYSE (MILS.)* | 137.7 | 140.4 | 112.0 | 108.4 | 29.6% |
| AMEX (MILS.)* | 10.3 | 12.8 | 7.3 | 8.2 | 56.4% |
| NASDAQ (MILS.)* | 110.7 | 119.9 | 72.4 | 78.6 | 52.6% |
| REGIONAL EXCHANGE (MILS.)* | 22.6 | 23.4 | 18.1 | 18.7 | 25.0% |
| DOLLAR VALUE OF SHARES TRADED ON | | | | | |
| NYSE (MILS.) | $118,057 | $794,553 | $88,134 | $561,107 | 41.6% |
| AMEX (MILS.) | 3,671 | 26,342 | 2,168 | 14,964 | 76.0% |
| ODD-LOT SHARES PURCHASED ON NYSE (THOUS.) | 9,143 | 65,074 | 7,393 | 48,942 | 33.0% |
| ODD-LOT SHARES SOLD (INCLUDING SHORT SALES) ON NYSE (THOUS.) | 17,422 | 129,095 | 15,600 | 109,993 | 17.4% |
| NYSE BLOCK VOLUME AS A PERCENT OF TOTAL SHARES TRADED | 49.6% | 49.4% | 53.3% | 51.8% | ---- |
| CONTRACTS TRADED (THOUS.) | | | | | |
| CBOE OPTIONS | 16,050 | 109,671 | 11,617 | 82,302 | 33.3% |
| AMEX OPTIONS | 5,806 | 29,958 | 3,128 | 19,714 | 52.0% |
| COMMODITY | 15,080 | 110,859 | 13,866 | 92,266 | 20.2% |

*MONTHLY AVERAGE

## YIELDS

(MONTHLY AVERAGES)

| | SEPTEMBER 1986 | SEPTEMBER 1985 | BASIS POINT CHG 1986-1985 |
|---|---|---|---|
| BOND BUYER INDEX (20 BOND) | 7.11% | 9.27% | (216) |
| CORPORATE BOND YIELDS (MOODY'S) | | | |
| Aaa CORPORATE | 8.89 | 11.07 | (218) |
| Baa CORPORATE | 10.20 | 12.48 | (228) |
| RATIO Aaa CORPS. TO Baa CORPS. | 0.87 | 0.89 | (2) |
| MUNICIPAL BOND YIELDS (MOODY'S) | 7.11 | 9.27 | (216) |

## PRICES
(END OF MONTH)

| | SEPTEMBER 1986 | SEPTEMBER 1985 | % CHAN. Y-T-D 1986-1985 |
|---|---|---|---|
| DOW JONES INDUSTRIALS | 1767.58 | 1328.63 | 33.04% |
| STANDARD & POOR'S 500 | 231.32 | 182.08 | 27.04% |
| NYSE COMPOSITE | 133.44 | 105.19 | 26.86% |
| AMEX MARKET VALUE INDEX | 260.69 | 222.31 | 17.26% |
| VALUE LINE COMPOSITE | 222.08 | 189.01 | 17.50% |
| NASDAQ COMPOSITE | 350.67 | 280.33 | 25.09% |

UNDERWRITING

| | SEPTEMBER 1986 | SEPTEMBER 1985 | % Change 1986-1985 |
|---|---|---|---|
| CORPORATE FINANCING (Gross New Issues - $ Mils) | | | |
| TOTAL | $16,431.2 | $10,561.8 | 55.6% |
| Common Stock | $1,585.8 | $2,215.7 | -28.4% |
| # of Common Stock Issues | 70 | 48 | 45.8% |
| Preferred Stock | $798.6 | $666.1 | 19.9% |
| # of Preferred Stock Issues | 9 | 9 | 0.0% |
| Corporate Debt | $14,046.7 | $7,680.0 | 82.9% |
| # of Corporate Debt Issues | 104 | 80 | 30.0% |
| MUNICIPAL FINANCING (Gross New Issues - $ Mils) | | | |
| Negotiated | $3,904.8 | $11,356.7 | -65.6% |
| # of Issues | 75 | 299 | -74.9% |
| Competitive | $1,277.0 | $2,324.2 | -45.1% |
| # of Issues | 38 | 90 | -57.8% |

Source: IDD Information Services

# RECENT INTERESTING READING AND STATISTICAL MATERIAL

| Item | Description | Source |
|---|---|---|
| Report on Office Salaries | Annual SIA survey providing detailed current information on compensation of 78 non-exempt clerical, secretarial, sales assistant, administrative, and "back office" positions. Also includes historical trends data and a breakdown of salaries in 26 major metropolitan areas as well as New York. | SIA<br>Survey Department<br>$400 Members<br>$1,200 Non-members |
| "Taxing Decision -- Should You Take Your Gains This Year?" | Example-filled article of factors to consider in making the decision to take long-term capital gains this year at 20%, given the rate increase to 28% in 1987. Also includes reference chart calculating gain needed to justify holding. | Barron's<br>10/6/86 |
| "Snapshots of the Third Quarter" | While Salomon has kept its lock on the number one spot in the underwriting rankings, Drexel Burnham and Morgan Stanley have secured their positions among the upper echelon this recent third quarter. Third quarter corporate underwritings totaled about $50 billion, compared with $75.6 billion in the second quarter. Underwriting ranking tables for first nine months of 1986. | Investment Dealers' Digest<br>10/6/86 |
| "The Recent Performance of the Commercial Banking Industry" | Summary article of the main findings of a bank study on the recent performance of the commercial banking industry and the factors that have influenced it. Aim of the study was to understand past rather than to foretell the future. Among the implications of the study is the fact that, outside the decline in banks' share of wholesale lending, there has been no substantial slippage in other traditional markets to date. | Quarterly Review<br>Federal Reserve Bank of New York<br>Summer 1986 |

| | | |
|---|---|---|
| "Foreign Banking in America -- 1985 Directory" | Accelerated worldwide banking deregulation and the continuing internationalization of corporate business activity has fueled the number of U.S. branches of foreign financial institutions. Although the rate of growth has slowed during the past two years, the number of foreign banks and securities firms with U.S. offices reached an all-time high of 459 as of July 30. Directory listing by country includes names of senior officers. | Institutional Investor<br>9/1/86 |
| "Futurescope" | A look at the factors affecting the securities industry and their impact. Globalization of capital markets was voted as the most dramatic event. The reason cited is the fact that a truly diversified portfolio must encompass not only different companies and industries, but also different countries, currencies, and demographics. Other factors reviewed: discount brokerage, bank competition and individual investors. | Registered Representative<br>September 1986 |
| Market Statistics 1986 -- CBOE | Handy 44-page reference booklet containing 1985 historical and statistical data on CBOE activity. Divided into 5 sections which include information on stock options, interest rate options and foreign currency options. | The Chicago Board<br>Options Exchange<br>LaSalle at Van Buren<br>Chicago, Illinois 60605 |
| Deposit Insurance - - Analysis of Reform Proposals | Comprehensive study published in two volumes. Major issues posed by deposit insurance reform are addressed. Supplementary information discusses: 1. how deposit insurance works, 2. interrelationships among bank risk, deposit insurance, and bank capital, 3. history of deposit insurance, 4. changes in the financial services industry that bring into question the special nature of insured deposits and institutions, and 5. the operations of individual funds. | U.S. General Accounting Office<br>P.O. Box 6015<br>Gaithersburg, Maryland 20877 |

# SIA/SEC FIRM CATEGORY LIST

(364 Firms as of 7/1/86)

1. National Full Line (10)
2. Large Investment Banks (10)
3. Small New York City (36)
4. Large New York City (36)
5. Small Regionals (40)
6. Medium Regionals (31)
7. Large Regionals (23)
8. Discounters (27)
9. Commission Introducing (114)
10. Other (37)

Based on 1985 unconsolidated FOCUS revenues:
Small NYC - under $20 million
Large NYC - $20 million or more
Small Regional - under $20 million
Medium Regional - $20 million to $70 million
Large Regional - $70 million or more

## NATIONAL FULL LINE

Drexel Burnham Lambert Inc.
A.G. Edwards & Sons, Inc.
E.F. Hutton & Co.
Merrill Lynch, Pierce, Fenner & Smith, Inc.
PaineWebber Inc.
Prudential-Bache Securities Inc.
Shearson Lehman Brothers Inc.
Smith Barney, Harris Upham & Co.
Thomson McKinnon Securities Inc.
Dean Witter Reynolds Inc.

## LARGE INVESTMENT BANKING

Bear, Stearns & Co.
Dillon, Read & Co.
First Boston Corp.
Goldman, Sachs & Co.
Kidder, Peabody & Co.
Lazard Freres & Co.
Morgan Stanley & Co.
L.F. Rothschild, Unterberg, Towbin Inc.
Salomon Brothers Inc
Wertheim & Co.

## SMALL NYC BASED

Baird, Patrick & Co.
BHF Securities
Burns Fry & Timmins Inc.
Challenge Securities Inc.
Doft & Co., Inc.
EuroPartners Securities Corp.
Evans & Co.
Gintelco Inc.
Oscar Gruss & Son Inc.
Haas Securities Corp.
Hornblower Fischer & Co. Inc.
Ingalls & Snyder
Invemed Associates Inc.
Jesup & Lamont Securities Co. Inc.
Kalb, Voorhis & Co.
Kleinwort Benson Inc.
Henry Krieger & Co.
Lepercq, de Neuflize Securities Inc.
Lieber & Co.
William D. Mayer & Co.
McLeod Young Weir Inc.
Muller & Co.
Nesbitt Thomson Securities, Inc.
Oxford Financial Group
Purcell Graham & Co.
Reich & Co.
Richardson Greenshields Securities Inc.
Seligman Securities, Inc.
Shatkin-Lee Securities Co.
J. Streicher & Co.
Swiss American Securities Inc.
Swiss Bank Corp. International Securities Inc.
Edward A. Viner & Co.
S.G. Warburg & Co.
H.G. Wellington & Co.
Wood Gundy Inc.

## LARGE NYC BASED

Arnhold & S. Bleichroeder Inc.
Asiel & Co.
Sanford C. Bernstein & Co.
D.H. Blair & Co.
Cowen & Co.
Cowen Securities Inc.
Daiwa Securities America Inc.
Deutsche Bank Capital Corp.
Dominick & Dominick Inc.
Dominick Investor Service Corp.
Dominion Securities Pitfield Inc.
Eberstadt Fleming Inc.
First Manhattan Co.
Furman Selz Mager Dietz & Birney Inc.
Glickenhaus & Co.
Gruntal & Co.
Herzog, Heine, Geduld, Inc.
Josephthal & Co.
Keefe Bruyette & Woods Inc.
Ladenburg Thalmann & Co.
Laidlaw Adams & Peck, Inc.
Cyrus J. Lawrence Inc.
Mabon Nugent & Co.
MKI Securities Corp.
Carl Marks & Co.
Moore & Schley, Cameron & Co.
Moseley Securities Corp.
Neuberger & Berman
Nikko Securities Co. International Inc.
Nomura Securities International Inc.
Oppenheimer & Co.
Philips Appel & Walden Inc.
Rothschild Inc.
Tucker, Anthony & R.L. Day, Inc.
UBS Securities Inc.
Walsh, Greenwood & Co.

## SMALL REGIONAL

Adams, Harkness & Hill, Inc.
Baker, Watts & Co.
Bartlett & Co.
Branch Cabell & Co.
Alan Bush Brokerage Co.
Butler, Wick & Co.
Cable Howse & Ragen
Carolina Securities Corp.
B.C. Christopher Securities Co.
Davenport & Co. of Virginia, Inc.
Equitable Securities Corp.
Ferris & Co.
Folger Nolan Fleming Douglas Inc.
Freehling & Co.
Gradison & Co.
Hanifen, Imhoff, Inc.
Hazlett, Burt & Watson, Inc.
Howe, Barnes & Johnson, Inc.
Wayne Hummer & Co.
Illinois Co.
Investment Corp. of Virginia
Legg Mason Masten Inc.
Midland Doherty Inc.
Milwaukee Co.
David A. Noyes & Co.
Parker/Hunter Inc.
Quinn & Co.
W.H. Reaves & Co.
Roulston Research Corp.
R. Rowland & Co.
Seidler Amdec Securities, Inc.
H.B. Shaine & Co.
I.M. Simon & Co.
Smith, Hague & Co.
Smith, Moore & Co.
Sterne, Agee & Leach, Inc.
Henry F. Swift & Co.
Weber, Hall, Sale & Associates, Inc.
Wilshire Associates
Young Smith & Peacock Inc.

## LARGE REGIONAL

Advest Inc.
Robert W. Baird & Co.
Bateman Eichler, Hill Richards, Inc.
William Blair & Co.
Blunt Ellis & Loewi Inc.
Boettcher & Co.
J.C. Bradford & Co.
Alex. Brown & Sons Inc.
Dain Bosworth Inc.
Interstate Securities Corp.
Janney Montgomery Scott Inc.
Johnson Lane Space Smith & Co.
Edward D. Jones & Co.
Legg Mason Wood Walker Inc.
Montgomery Securities
Piper, Jaffray & Hopwood Inc.
Prescott, Ball & Turben, Inc.
Rauscher Pierce Refsnes, Inc.
Robinson-Humphrey Co.
Rotan Mosle Inc.
Sutro & Co.
Wedbush, Noble, Cooke, Inc.
Wheat, First Securities, Inc.

## DISCOUNTERS

Baker & Co.
Brown & Co. Securities Corp.
Discount Brokers International, Inc.
Fidelity Brokerage Services Inc.
Gallagher Equities Inc.
Liss, Tenner & Goldberg Securities Corp.
National Financial Services Corp.
Newbridge Securities Inc.
Norstar Brokerage Corp.
Olde & Co.
Ovest Financial Services Inc.
Pace Securities, Inc.
Pacific Brokerage Services, Inc.
People's Securities Inc.
Quick & Reilly, Inc.
Rose & Co. Investment Brokers Inc.
Royal/Grimm & Davis, Inc.
Russo Securities Inc.
Charles Schwab & Co.
Security Pacific Brokers, Inc.
Muriel Siebert & Co.
Stockcross, Inc.
Texas First Brokerage Services, Inc.
Tradex Brokerage Service, Inc.
Wall Street Discount Corp.
Waterhouse Securities Inc.
York Securities, Inc.

## COMMISSION INTRODUCING

Abel/Noser Corp.
Alpha Management Inc.
American Investment Group Inc.
Amivest Corp.
Anderson & Strudwick Inc.
Atlanta/Sosnoff Management Corp.
Balfour Securities Corp.
Balis & Zorn Inc.
Bernstein & Co.
Bishop Rosen & Co.
Blackburn & Co.
Blumenthal Securities, Inc.
Boston Institutional Services Inc.
Bradley Hummel & Co.
Brault Stafford & Co.
Bridge Trading Co.
Brimberg & Co.
Brittingham Inc.
A.T. Brod & Co.
Buckingham Research Group Inc.
N.B. Camerman & Co.
Capital Institutional Services, Inc.
Cohen Feit & Co.
Coleman & Co.
Collins & Co.
Comiteau Levine & Co.
Conklin Cahill Inc.
Conning & Co.
Corporate Bonds Inc.
Cresvale International Inc.
Daniels & Bell Inc.
Morris David & Sons Securities Inc.
Delafield Harvey Tabell Inc.
dePaolis & Co.
Douglas Stewart Inc.
Dratel Group Inc.
Dunhill Securities Inc.
Dunlevy & Co.
Federated Management Inc.
Fiduciary Financial Services Corp.
Finch Wilson & Co.
First Tryon Securities Inc.
Fourteen Research Corp.

COMMISSION INTRODUCING (Cont'd)

Stuart Frankel & Co.
Furman Anderson & Co.
Gilder Gagnon & Co.
C.L. Glazer & Co.
Goetz Batchker & Co.
Gordon Capital Inc.
Gordon Haskett Capital Corp.
Gordon Haskett & Co.
Frederick J. Graber & Co.
David J. Greene & Co.
Grenel & Co.
Gruss & Co.
Haberman Bros.
Hamershlag Kempner & Co.
Bernard Herold & Co.
P.R. Herzig & Co.
Hess Grant & Co.
Hoenig & Co.
Hoguet Muzinich Keller & Co.
Impact Securities Corp.
Kahn Brothers & Co.
Keane Securities Co.
M. Kimelman & Co.
Lipper Analytical Securities Corp.
Loeb Partners Corp.
Lynch Jones & Ryan
Marketfield Securities Ltd.
McConnell Securities Inc.
H.J. Meyers & Co.
Montag & Joselson
Moors & Cabot Inc.
Brean Murray Foster Securities Inc.
Ochsenhaut & Co.
William O'Neil & Co.
Pennsylvania Group Inc.
Propp & Co.
Reich & Tang Inc.
Reinert & Co. Inc.
David H. Rittmaster & Co.
Rochdale Securities Corp.
Rosenkrantz Lyon & Ross Inc.
Ruane Cunniff & Co. Inc.
Frank Russell Securities Inc.
Seligmann Harris & Co.
Sheriff Securities Corp.
Shields Capital Corp.
A. Gary Shilling & Co.
Shoenberg, Hieber Inc.
Shufro Rose & Ehrman
Silberberg Rosenthal & Co.
Martin Simpson & Co.
Sloate Weisman Murray & Co.
Spear Leeds & Kellogg Corp.

## COMMISSION INTRODUCING (Cont'd)

R.C. Stamm & Co.
Standard & Poor's Securities Inc.
Starr Securities Inc.
Sterling Grace & Co.
Stralem & Co.
Strasbourger Pearson Tulcin Wolff Inc.
Stuart Coleman & Co.
T.J. Sullivan & Co.
Swergold, Chefitz & Sinsabaugh, Inc.
Troster Singer Corp.
Trubee Collins & Co.
Value Line Securities Inc.
W & D Securities Inc.
H.C. Wainwright & Co.
S.R. Weltz Jr. & Co.
Westminster Securities Corp.
Woodmere Securities Inc.
B.J. Young & Co.

## OTHER

Adler, Coleman & Co.
Fred Alger & Co.
Beare Brothers & Co.
Boston Securities Associates, Inc.
Broadcourt Capital Corp.
Brokerage Clearance Services Inc.
Brown Brothers Harriman & Co.
P.R. Burke & Co.
Shelby Cullom Davis & Co.
Donaldson Lufkin & Jenrette Sec. Corp.
Ernst & Co.
Execution Services Inc.
Financial Clearing & Services Corp.
First Options of Chicago Inc.
Freeman Securities Co.
Albert Fried & Co.
Goldberg Securities Inc.
Icahn & Co.
Investors Advantage Inc.
Kaufmann, Alsberg & Co.
Kellner, Dileo & Co.
Lewco Securities Corp.
Miller Tabak Hirsch & Co.
Murphey, Marseilles, Smith & Nammack
New York & Foreign Securities Corp.
Paris Securities Corp.
Carl H. Pforzheimer & Co.
Wm. E. Pollock & Co.
Regional Clearing Corp.
Robb, Peck, McCooey Clearing Corp.
Robb, Peck, McCooey/Trading Corp.
Securities Settlement Corp.
Spear, Leeds & Kellogg
Stokes, Hoyt & Co.
Transatlantic Securities Co.
Wall Street Clearing Co.
Weiss, Peck & Greer